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Annex to the

Second Implementation Report on the

2003-2005 Broad Economic Policy Guidelines

- -Part I General part-

{COM(2005)8 final}

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1. INTRODUCTION

Timely and effective implementation of the EU's medium-term policy strategy is of the highest importance for fulfilling the Union's ambitions as regards sustainable economic growth, employment and social cohesion. This annual Implementation Report reviews the progress made by Member States and the Union in implementing the economic policy strategy as laid down in the 2003-05 Broad Economic Policy Guidelines (BEPGs)[1]. It provides a key input for the multilateral surveillance of the economic policies of the Member States and the Union as envisaged by the Treaty. It is presented as part of the 'Implementation Package' together with the draft Joint Employment Report and the Implementation Report on the Internal Market Strategy. Together they give essential background information to the Commission's 2005 Spring Report. In turn, the 2005 Spring Report, together with the recent report of the High-Level Group chaired by Mr. Wim Kok, prepares the ground for the upcoming Mid-Term Review of the Lisbon Strategy.

The BEPGs set out the contribution economic policies can make to the Lisbon strategy through a comprehensive strategy concerning macro-economic policies, economic reforms and sustainability. Whereas last year's Implementation Report[2] focussed to a great extent on policy intentions, this second Implementation Report on the 2003-05 BEPGs shifts the attention to policy measures taken and/or envisaged. Rather than limiting the assessment to policy actions in 2004, an incremental approach is used, by reviewing and assessing policy measures since the adoption of the guidelines in 2003.

The 2004 update of the BEPGs confirmed the validity and relevance of the general guidelines, also for the new Member States, and updated the country-specific budgetary recommendations to seven Member States[3]. The main focus of the 2004 update was the integration of the recently acceded Member States into the existing framework for economic policy coordination. Country-specific challenges and recommendations for 2004 and 2005 were established, taking due account of the individual performances, prospects, structures and institutions of the new Member States.

This working document of the Commission services starts with a review of the follow-up given to the 23 general guidelines applicable to all Member States and to the Union, followed by the assessment on the implementation of the five guidelines specifically directed to the euro area. Subsequently, there is a summary assessment of the implementation of the country-specific recommendations. The second part of this document provides a detailed assessment of the implementation of the recommendations given to address the individual challenges on a country-by-country basis. The assessment takes into account the limited time that newly acceded Member States have had to follow-up on the guidelines.

1 Council recommendation of 26 June 2003 on the broad guidelines of economic policies of the Member States and the Community (for the 2003-05 period), 2003/555/EC, published in the Official Journal No. L 195/1 of 1 August 2003.

2 Commission Communication 'First Report on the Implementation of the 2003-2005 Broad Economic Policy Guidelines', COM (2004) 20 final, adopted on 21 January 2004.

3 Council recommendation of 5 July 2004 on the 2004 update of the broad economic policy guidelines for the period 2003-2005.

Box 1: Progress in delivering on the three priorities of growth, labour market flexibility and sustainable public finances

When the Ecofin Council adopted the 2003-05 Broad Economic Policy Guidelines (BEPGs) in June 2003, it identified three main priorities for policy action: growth, labour market flexibility and sustainable public finances. Against the background of an economic recovery lagging behind the global pace, the Council has paid considerable attention in 2004 to the first priority. This box only gives a broad overview of the measures taken in response to these three key-priorities. More detail is to be found in the full report.

1. **Promoting economic growth**. Looking at the last two years, macro-economic policies were supportive to growth. Monetary policies in most Member States were accommodative. Since the cut in interest rates in June 2003, the ECB kept its key-interest rate at the historically low level of 2 per cent. The budgetary stance in both 2003 and 2004 has remained broadly neutral. In addition to sound macro-economic policies, the Council called for higher investment in human and physical capital and the completion of the Internal market. While the public investment in education seems to stabilise, public investments in physical capital have slightly increased. Over the last few years public investment-ratios increased significantly in new Member States such as Malta, Czech Republic and Poland but also in e.g. the United Kingdom. At the European level the European Growth Initiative aimed at investments in key infrastructural projects, was launched in 2003, but so far only one transport infrastructural project and one energy project has actually started. The pace of Internal Market integration appears to have slowed down, but financial market integration has progressed further with the legislative phase of the Financial Services Action Plan now nearly completed.

It can be noted that in 2004, Eurogroup ministers had discussions on the assessment of the structural weaknesses of the euro area in light of the growth performance and discussed how growth could be enhanced in a budget neutral way. Options in this regard related to reducing the administrative burden, improving the quality of public finance and stimulating competition in sheltered sectors. These options underline the importance of a timely implementation of all the guidelines aimed at raising Europe’s growth potential.

2. **Increasing labour market flexibility**. The Ecofin Council specifically called for tax-benefit reforms and greater incentives to take up employment in most Member States. After a slight improvement in 2003, the pace of labour market reforms appears to have been sustained in 2004 reflecting above all substantial measures proposed in Germany in 2004. In most Member States good progress has been made over the last two years in cutting taxes or providing lifelong learning strategies, but the objective of achieving 12.5 per cent rate of adult participation in lifelong learning remains difficult to achieve. Fewer, or less comprehensive, measures relate to benefit systems, wage bargaining and employment protection legislation (and in particular for permanent contracts) that can affect labour market participation to a greater extent. Some Member States have implemented measures in the area of active labour market policies to increase the role of incentives and targeting on specific groups.

3. **Ensuring public finance sustainability**. Besides further consolidating public finances and raising employment rates most Member States needed, according to the Ecofin Council, to engage in far-reaching pension and health care reforms. Whereas substantial pension reforms have been implemented in 2003 and 2004 in France, Italy, Austria and Slovakia, progress in a number of other Member States with unsustainable public finances has been limited. Health-care reforms have been implemented in Germany, France, Portugal and Slovakia, but these were exceptions among the 25 Member States. As most of these health care reforms were aimed at containing rising health care costs, they constitute welcome steps in timely addressing the pressures on health care expenditures stemming from ageing populations.

2. Implementation assessment of the general guidelines

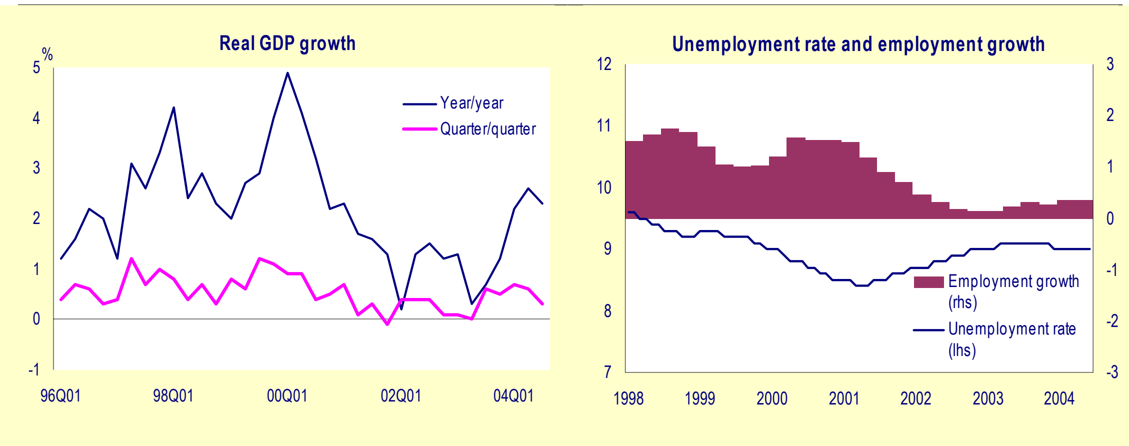
2.1 Growth- and stability-oriented macroeconomic policies

2.1.1 Economic background: moderate economic recovery in 2004

The implementation of the 2003-05 BEPGs started in the year that recorded the lowest economic growth since 1993. In 2003, economic growth in the Union dipped to just 1 per cent, while growth in the euro area barely exceeded ½ per cent. On the back of a strong surge in world trade, the EU economy started to recover in the second half of 2003, and strengthened during the first half of 2004. Data for the third quarter of 2004 are consistent with earlier projections of an average growth rate of 2½ per cent for the EU-25 and around 2 per cent in the euro area. While this performance was markedly better than during the period 2001-2003, it was mainly driven by buoyant external demand. Domestic demand (notably investments), on the other hand, stayed below what might be expected at this stage of the recovery. This suggests that the combination of supportive financial conditions, improving profit margins and accommodative macroeconomic policies has not yet been able to boost confidence, to accelerate investment expenditure and to trigger a pick-up in private consumption.

The economic slowdown of 2001-2003 did not affect the labour market to the same extent as earlier slowdowns, as witnessed by e.g. the more limited rise in unemployment. The unemployment rate rose gradually to about 9 per cent in 2003 in both the EU-25 and the euro-area, and it is expected to have stabilised on that level in 2004. The faster pace of economic growth has translated into a gradual, albeit still modest growth of employment. Job creation of around ½ per cent in 2004, correspond to 0.8 million jobs in the EU-25, of which 0.5 million in the euro area.

Graph 2.1: Economic developments in the EU



Source: Commission services.

Inflation did not come down significantly despite the weak economic growth over recent years. In 2003, inflation remained close to 2 per cent in the EU and the euro area, partly due to adverse shocks such as the acceleration of food prices. Another relevant factor was the upward pressure coming from increasing unit labour costs. For 2004, inflation is estimated at 2.2 per cent in the EU and the euro area.

Headline inflation has been pushed up by higher energy prices while core inflation remained sticky as a result of high services inflation and increases in indirect taxes, particularly on tobacco, in several Member States. For the euro area, the appreciation of the euro provided some counterweight to the rising commodity prices but the adjustment of consumer prices resulting from downward pressures on import prices seems to have been slow.

Macroeconomic policy conditions remained conducive to economic growth

The macroeconomic policy stance remained broadly accommodative as the recovery gradually gained pace in 2004.

Following the 50 basis points cut in interest rates to the historically low level of 2 per cent in June 2003, the ECB left policy rates unchanged throughout 2004 against the background of limited inflationary pressures. The positive influence of low interest rates on economic activity was mitigated by the rise of the nominal effective exchange rate, which appreciated on average in 2004 by 4 per cent compared to the average over 2003. Taking the short-term interest rates and real effective exchange rates in this period together, monetary conditions have loosened slightly. With inflation staying close to 2 per cent in both 2003 and 2004 the monetary authorities in the euro area succeeded in maintaining price stability.

Table 2.1: Short term and long term interest rates in the EU in 2004

	EU-12	CZ	DK	EE	CY	LV	LT	HU	MT	PL	SL	SK	SE	UK
Short-term nominal interest rates	2.1	2.4	2.2	2.5	4.7	4.2	2.7	11.4	3.0	6.0	4.7	4.8	2.3	4.6
Change from 2003	*-0.2*	*0.1*	*-0.2*	*-0.4*	*0.8*	*0.4*	*-0.1*	*2.9*	*-0.3*	*0.3*	*-2.1*	*-1.4*	*-0.9*	*0.9*
Long-term nominal interest rates	4.2	5.0	4.5	4.5	5.8	5.0	4.6	8.4	4.7	7.2	4.8	5.1	4.6	5.1
Change from 2003	*0.1*	*0.9*	*0.2*	*-0.8*	*1.1*	*0.1*	*-0.7*	*1.6*	*-0.3*	*1.4*	*-0.6*	*0.1*	*0.0*	*0.5*

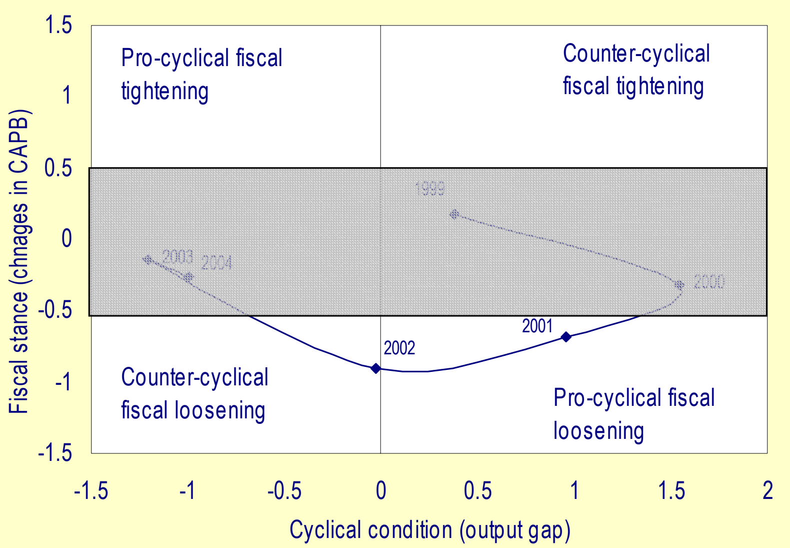
Notes: Nominal short-tem interest rates are defined as the 3-month interbank rates. Nominal long term interest rates are defined as the central government benchmark bond of 10 years.

Source: Commission services, Autumn 2004 Economic Forecasts.

Elsewhere in the EU, several central banks raised policy rates in the last two years. Anticipating emerging price pressures, the Bank of England started to raise interest rates in November 2003 followed by a cumulative 1 percentage point rise in 2004 to a level of 4.75 per cent. The monetary authorities in some of the newly acceded Member States have adopted a different monetary policy stance during the last two years. The Hungarian central bank, in particular, has maintained a tight monetary policy amounting to a very steep increase in interest rates by 600 basis-points in the second half of 2003. In 2004, it eased interest rates gradually by a total of 300 basis points.

The fiscal policy stance in the euro area and the EU-15 was broadly neutral in 2004 as was also the case in 2003. The fiscal stance is measured by changes in the cyclically adjusted primary balance[4]. The pick up in economic activity in 2004 was not yet visible in the nominal budget balance, which is estimated to have remained unchanged for the EU-25 and to have increased to just below the 3 percent ceiling for the euro area.

Graph 2.2: Fiscal stance and cyclical conditions in EU-15[1]



[1] The ten new Member States are not included because comparable data do not yet exist. The shaded area represents a broadly neutral stance.
Source: Commission services.

Wage developments are also crucial in determining overall macroeconomic conditions. While slow to come down early in the cycle, and thereby having put upward pressure on unit labour costs and inflation, steady and moderate wage growth over the recent years has, in the light of a cyclical recovery in productivity, contributed to keeping a lid on inflationary pressures. In the euro area wage growth dropped from 2.6 per cent to 2.2 per cent, although inflation remained unchanged. Given the cyclical increase of labour productivity growth, nominal unit labour costs decreased in 2004 to 0.6 per cent.

2.1.2 Budgetary developments: a majority of Member States are struggling with high deficits

Following a surplus in 2000, reflecting the economic upswing and the receipts arising from the allocation of mobile phone licences, the budget balance in the EU turned negative again to a deficit of more than 2 per cent of GDP by 2002. This was due to both the play of automatic stabilisers and discretionary policies, but with sizeable differences recorded across Member States. Budget deficits were substantial, and in some cases above the 3 per cent of GDP excessive deficit ceiling, while only three Member States recorded a considerable surplus. Public finances continued to deteriorate in 2003 due to the lacklustre growth, with an almost unchanged cyclically-adjusted budget balance while net borrowing increased, narrowing further

[4] Due to the absence of cyclically-adjusted balances for the new Member States no assessment can be made for the Union as a whole. However, based on the development of the nominal balances of the ten new Member States, in combination with their growth performance, it seems unlikely that the picture of the EU-25 would be different.

the distance to the deficit ceiling. For the EU as a whole, the budget deficit is expected to have remained unchanged in 2004.

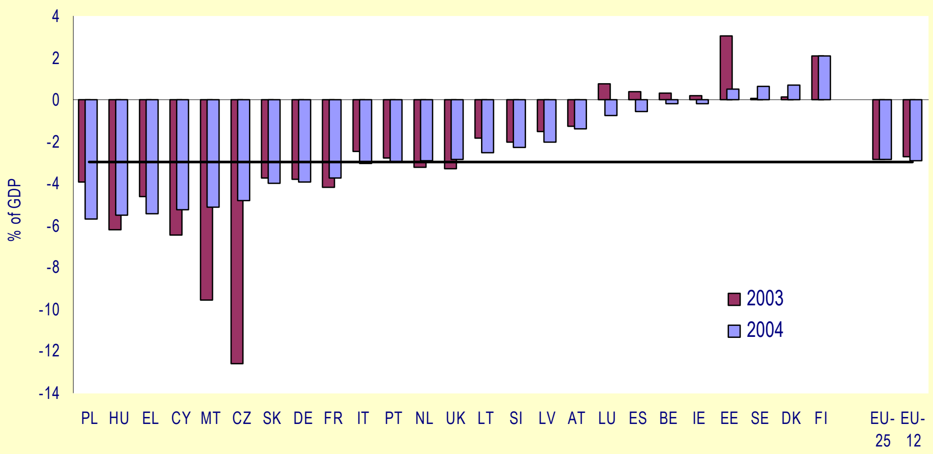
Against this background, the 2003-05 BEPGs recommended Member States to:

1. reach or maintain budgetary positions of close to balance or in surplus throughout the economic cycle; to correct excessive deficits in line with the Stability and Growth Pact;

2. subject to (1), avoid pro-cyclical policies, in particular in economic upturns.

While the economic cycle was the main factor behind the deterioration in public finances in recent years, some of the deterioration also stemmed from a discretionary loosening of fiscal policy. However, differences are notable across Member States. Almost all Member States that had already sizeable nominal deficits further loosened their fiscal stance, whilst Member States with small deficits or surpluses maintained a broadly neutral stance. Public finances continued to deteriorate in 2003 due to the lacklustre growth, with an almost unchanged cyclically-adjusted budget balance, while net borrowing increased to 2.7 per cent on average, both in the EU-15 and the euro area. Against this background it was deemed appropriate to keep the general budgetary guidelines unchanged in the 2004 update of the BEPGs. On the other hand, the lack of improvement and/or the rapid deterioration noted in some countries triggered updates of the budgetary country-specific recommendations to Germany, Greece, France, Italy, the Netherlands and Portugal and a new challenge was introduced in the case of the United Kingdom.

Graph 2.3: General government balances by Member State, the euro area and for EU-25



Source: Autumn 2004 Commission forecasts.

The 2004 update of the BEPGs found that the existing economic policy strategy was broadly appropriate for the ten new Member States that entered the Union on 1 May 2004. However, as regards the need to 'reach or maintain sound budgetary positions', it was felt that an appropriate time path had to be found to balance the speed of the necessary budget consolidation and a fiscal stance supporting the ongoing structural adjustment of their economies. Therefore, a multi-annual adjustment period was allowed to some of these countries with a deficit above 3 per cent of GDP. With the general budgetary guidelines in mind and while taking due account of differences in their economic performances, prospects, structures and institutions, country-specific budgetary recommendations were issued to almost all new Member States.

According to the Commission Autumn 2004 Economic Forecasts, in 2004, the fiscal deficit for the euro area is expected to increase for a fourth consecutive year and the deficit is projected to be 2.9 per cent of GDP in 2004 whereas it is projected to decline to 2.5 per cent of GDP in 2005. For the EU as a whole, the nominal aggregate deficit in 2004 is projected to stay at 2.8 per cent of GDP (as in 2003) and to decline to 2.4 per cent of GDP in 2005. Against this background, a further rise in the debt-to-GDP ratio is projected in 2004.

In 2003, the budget deficits in four euro-area Member States were equal to or above 3 per cent of GDP – Germany, France, Greece and the Netherlands. In 2004, the Netherlands are projected to have reduced their budget deficit to below the reference value, while Italy is expected to reach it. The above-mentioned overall improvement in 2005 relies strongly on the expected budgetary consolidation in Germany and France. Nevertheless, apart from the Netherlands, none of the countries currently in the excessive deficit procedure is expected to have the deficit below the reference value in 2005, unless further consolidation measures are adopted. In addition, of the ten new Member States, six had deficits higher than 3 per cent of GDP in 2003. In 2004, only Poland and Slovakia are not expected to improve their nominal deficits and the deficits in all six are projected to stay above the reference value[5].

Table 2.2: Cyclically-adjusted budget balance in the euro area and EU-15 (in percentage of GDP)

	Cyclically-adjusted budget balance (CABB)[1]			Change in CABB[1]	
	2003	**2004**	**2005**	**2004**	**2005**
BE	1.1	0.4	0.0	-0.7	-0.4
DE	-3.0	-3.4	-2.9	-0.4	0.5
EL	-5.1	-6.1	-4.4	-1	1.7
ES	0.2	-0.7	-0.1	-0.9	0.6
FR	-3.8	-3.5	-2.8	0.3	0.7
IE	0.1	0.1	0.0	0	-0.1
IT	-1.9	-2.4	-2.6	-0.5	-0.2
LU	1.7	0.4	0.3	-1.3	-0.1
NL	-1.8	-1.4	-1.0	0.4	0.4
AT	-0.8	-1.0	-1.9	-0.2	-0.9
PT	-1.9	-1.9	-2.7	0	-0.8
FI	2.8	2.8	2.3	0	-0.5
Euro Area	**-2.2**	**-2.5**	**-2.1**	**-0.3**	**0.4**
DK	1.2	1.5	1.8	0.3	0.3
SE	1.4	0.7	0.4	-0.7	-0.3
UK	-2.9	-2.7	-2.4	0.2	0.3
EU-15	**-2.2**	**-2.3**	**-2.0**	**-0.1**	**0.3**

[1] On the basis of the production function method, except in the case of Spain where the HP filter method has been used. For the new Member States cyclically adjusted balances are not yet available.

Source: Commission services, Autumn 2004 Economic forecasts.

[5] For more detailed information, see also box 1 in Annex 1, which contains an overview of measures taken by Member States in response to country-specific recommendations in this area.

When making comparisons between Member States, due notice should be taken of one-off operations influencing the overall picture. In Spain, one-off measures (consisting mainly of the assumption of the Railway Network Company's debt by the Central government, amounting to 0.7 per cent of GDP) taken by the new government in 2004 caused the balance to turn into a deficit in 2004. One-off measures were instrumental in achieving a balanced position in Belgium in 2003 and 2004, but will cease to influence the budget as of 2005. In Italy, one-off measures amounting to more than 2 per cent of GDP helped contain the deficit in 2003 and in the autumn 2004 forecast such measures are projected to reduce the budget deficit by 1½ and ½ per cent of GDP in 2004 and 2005, respectively. In Portugal, two one-off measures (worth more than 2 per cent of GDP) contributed to bringing the budget deficit below 3 per cent of GDP in 2003. For 2004, the Portuguese government is planning further one-off operations worth 2 per cent of GDP and additional one-offs are envisaged for 2005 (some of these are pending a final decision of Eurostat). A significant part of the deficit reduction projected for 2005 in France stems from one-off revenues amounting to ½% of GDP (transfer of the responsibility to the social security sector for the payment of pensions to EDF-GDF employees). One-off measures were also important in the Czech Republic (where the 2003 deficit includes a state guarantee of some 7 per cent of GDP) and Malta (where the restructuring of the shipyard industry added more than 3 per cent to the 2003 deficit).

Of the seven EU-15 Member States that had reached or maintained a budget position of close to balance or in surplus in cyclically-adjusted terms in 2003 (see Table 2.2), the Commission's Autumn 2004 Economic Forecasts project that they maintained such a position also in 2004 and 2005, though with recourse to considerable one-off measures in some Member States (and with the exception of Spain in 2004), as noted above. As regards the new Member States, the lack of cyclically-adjusted budget balances hampers the comparison with the EU-15 Member States[6]. Estonia had achieved a fiscal surplus in 2003 and a lower surplus is projected in 2004 and 2005, alongside with a widening of the negative output gap in both these years. Of the eight EU-15 Member States not yet having achieved a balanced budget position in 2003, three improved their cyclically-adjusted budget balance (CAB) in 2004, namely France, the Netherlands and the United Kingdom. By contrast, a deterioration of the CAB is projected in Germany, Greece, Italy, and Austria in 2004. In 2005, an improvement of the CAB is projected (on current policies) in most of these countries. However, a deterioration is projected in Italy, Austria and Portugal.

Nine of the new Member States had a deficit in 2003. It is projected to decline in the Czech Republic, Cyprus, Hungary and Malta in 2004, aided by growth above potential in the first three. By contrast, a higher deficit is projected in 2004 in five countries, despite improved cyclical conditions. In 2005, fiscal consolidation is projected in all nine countries, except in Latvia and Slovakia, and in general in combination with a smaller effect of the cycle.

Overall, on the basis of the budgetary projections in the Commission's Autumn 2004 Economic Forecasts, further budgetary consolidation is of utmost importance for a

[6] Work is currently ongoing in the OECD and the EPC to allow for calculations of budgetary elasticities and thereby of cyclically adjusted balances for the new Member States. This work was however not finished in time for the publication of the present report. The lack of cyclically-adjusted budget data makes it impossible so far to include the new Member States in fully a systematic and comparable way in the follow-up to guidelines no. 1-2.

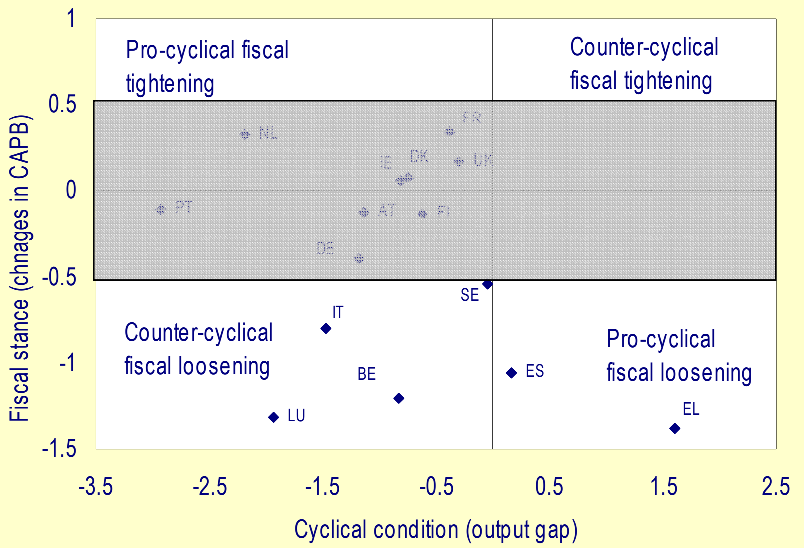
number of Member States, not least in view of the prospects of putting an end to the excessive deficits prevailing in several Member States.

Excessive deficits were identified in Portugal (in 2002), Germany and France (both in 2003). With the deficit outcome for 2003 below 3 per cent of GDP, the excessive deficit procedure for Portugal was abrogated by the Council on 11 May 2004; however, a renewed breach of the 3 per cent limit cannot be excluded. In Germany and France, the deficit remained well above 3 per cent of GDP in 2004. In Germany, the deficit widened marginally with cyclical conditions partly to blame as the composition of growth was tax unfriendly. By contrast, the deficit in France could have narrowed more significantly if the additional revenues from higher-than-expected growth had been allocated in full to deficit reduction.

In 2004, eight more Member States were found to be in excessive deficit, namely the Czech Republic, Greece, Cyprus, Hungary, Malta, the Netherlands, Poland and Slovakia. The Council recommended that Greece, Cyprus and the Netherlands correct their excessive deficit by 2005; for Greece, this now looks particularly challenging in view of the recent, substantial upward revision of the deficit. The remaining five countries were requested to pursue fiscal consolidation in line with their convergence programme, with the excessive deficits to be corrected by 2006 (Malta), 2007 (Poland and Slovakia) or 2008 (Czech Republic and Hungary) and with the exception of Hungary, implementation of the fiscal consolidation efforts seems broadly on track. As regards Italy, which was recommended in the 2004 update of the BEPGs “to take appropriate measures” in response to the possible existence of an excessive deficit, the Council decided not to issue the early warning recommended by the Commission in view of the savings package announced by the Italian authorities in July 2004. However, there is still a risk that the 3 per cent of GDP ceiling has been breached in 2004 or will be breached in 2005.

The overall fiscal stance (approximated by the changes in the cyclically-adjusted primary balance (CAPB)) was estimated to be broadly neutral in 2003 and 2004 in the euro-area and EU-15 and seen in relation to cyclical conditions (measured with the level of the output gap). The aggregate fiscal stance results from quite diverse fiscal stances across Member States, despite fairly similar cyclical developments (see Graph 2.4). For instance, several Member States are expected to run somewhat pro-cyclical policies, reflecting the further consolidation efforts needed to fulfil the guideline on sound budgetary positions (e.g. France and the Netherlands), although this could not explain the pro-cyclical fiscal stance noted in Greece. As regards the new Member States, the fiscal stance in Hungary, Latvia and Lithuania requires attention: fiscal policies in 2004 seem to have been either loosened or exhibiting a lack of consolidation efforts in response to higher-than-expected revenues, despite the country-specific recommendation to avoid pro-cyclical policies. In general and in view of the lack of action already mentioned, it appears vital that the fiscal stance is tightened when economic conditions improve in several Member States in order to ensure sufficient room for the automatic stabilisers to operate fully in the next economic downturn.

Graph 2.4: Fiscal stance and cyclical conditions in the EU-15[1] in 2004



[1] The new Member States are not included because comparable data do not yet exist. The shaded area represents a broadly neutral stance.
Source: Commission services.

Overall, the lack of resolve to address and/or avoid the (excessive deficit) situation in some Member States continues to be a source of great concern. In light of the experience of the multilateral budgetary surveillance and with a view to strengthening economic governance and clarifying the implementation of the Stability and Growth Pact (SGP), the Commission has adopted two Communications in 2004[7], advocating better interlinking the instruments for EU economic governance (BEPGs and the SGP) in order to enhance the contribution of budgetary policy to economic growth. The Commission also proposes that the SGP would benefit from an increased focus on the sustainability of public finances and increased recognition of the different economic situations in an enlarged Union of 25.

2.1.3 Wage developments: now better tuned to support employment creation

While wage hikes declined less than productivity during the recent prolonged period of slow growth …

Wages responded only modestly to the protracted slow growth in recent years, partly reflecting a greater resilience shown in the labour market during this slowdown. Nominal wage growth fell gradually from 3½ per cent in 2000 to around 3 per cent in 2003 in the EU-15, while it remained relatively stable around 2¾ per cent in the euro area during the same period. Unit labour costs increased, however, as labour productivity growth declined sharply early in the slowdown reflecting mainly labour hoarding in several Member States.

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

3. ensure that nominal wage increases are consistent with price stability and productivity gains.

[7] COM (2004) 425 final of June 2004 and COM (2004) 581 final of September 2004. The Council has held a first discussion on 10 September 2004 on how to strengthen and clarify the Pact and ensure better implementation.

... labour cost pressures have eased with the recovery

Overall, nominal wage increases eased very slightly in 2004 in the EU-25 and the EU-15 (to 3 per cent and 2¾ per cent respectively), and somewhat more in the euro area (to 2¼ per cent). Such wage increases are generally in line with price stability in the medium term. Moreover, the strengthening of the economy has resulted in a cyclical recovery of labour productivity, clearly up from the depressed levels of the preceding three years. As a corollary, the rise in unit labour costs decelerated below 1 per cent. This reduction in domestic price pressures is particularly beneficial at times of heightened external risks to price stability.

Table 2.3: Wage developments in 2004

	Nominal compensation per employee	Real wages [1]	Labour Productivity	NULC [2]	RULC [3]
BE	2.7	0.7	2.1	0.6	-1.4
DE	0.0	-1.0	1.8	-1.7	-2.7
EL	6.5	2.8	2.0	4.4	0.8
ES	3.7	-0.1	0.6	3.1	-0.7
FR	3.3	1.4	2.7	0.6	-1.2
IE	5.4	2.3	2.7	2.6	-0.4
IT	3.4	0.5	0.5	2.9	0.1
LU	3.3	1.0	1.9	1.3	-0.9
NL	2.4	1.5	3.2	-0.8	-1.6
AT	2.5	1.4	1.4	1.1	0.0
PT	3.1	1.1	0.9	2.2	0.2
FI	4.1	3.7	3.5	0.6	0.2
Euro area	**2.2**	**0.3**	**1.6**	**0.6**	**-1.3**
CZ	6.4	1.6	4.7	1.7	-3.0
DK	3.3	1.4	1.9	1.4	-0.4
EE	8.6	4.6	5.6	2.9	-0.9
CY	4.0	1.0	2.4	1.6	-1.4
LV	14.0	6.8	6.7	6.9	0.1
LT	7.8	6.0	5.5	2.2	0.5
HU	8.8	2.5	3.4	5.2	-0.9
MT	0.6	-2.7	0.4	0.2	-3.1
PL	4.7	1.8	6.0	-1.3	-4.0
SI	6.0	1.8	3.8	2.2	-1.9
SK	9.9	5.7	5.0	4.7	0.7
SE	3.4	2.3	4.3	-0.9	-1.9
UK	5.2	2.8	2.6	2.6	0.2
EU-25	**3.0**	**0.9**	**2.1**	**0.9**	**-1.1**

[1] Nominal compensation adjusted by the GDP deflator.
[2] Nominal unit labour costs.
[3] Real unit labour costs.
Source: Commission services, Autumn 2004 Economic Forecasts.

Furthermore, the advances in productivity also allowed, for the first time since 1998, a noticeable easing in real unit labour costs, which should underpin a rebound in investment (see Table 2.3 above).

The picture is more diverse at the country level. Within the euro area, nominal wage increases were relatively high in Greece, Ireland and Finland, i.e. countries with comparatively strong economies and/or tight labour markets while wage growth was subdued in Germany where still weak labour market trends triggered agreements on cost reductions. Cost competitiveness in terms of unit labour costs decreased above all in Greece, Spain and Italy, but improved in Germany and the Netherlands. This extends recent trends, except for Greece, where the improvement seen in 2003 was discontinued with the 2004 two-year wage agreement, and the Netherlands, where a turnaround was reached after the preceding dip in activity.

Wage related country-specific guidelines were addressed to two euro-area countries. In Ireland the fairly moderate private sector wage settlements of summer 2004 are reassuring in terms of price competitiveness, notwithstanding faster public sector pay awards, reflecting a gradual adjustment in pay scales relative to the private sector. In Portugal wage growth clearly decelerated in the aftermath of the 2003 recession, supported also by a partial wage freeze in the public sector, thereby containing the erosion in competitiveness.

Outside the euro area, nominal wage growth began to pick up in the United Kingdom, reflecting the tight labour market situation. A higher pace of wage increases prevailed in 2004 in most of the recently acceded Member States. Generally good advances in productivity were achieved, but nominal unit labour costs still rose quite fast in Latvia and Slovakia. A deceleration, in continuation of what already occurred in Hungary and Slovakia relative to 2003, would sustain the currently good export performance.

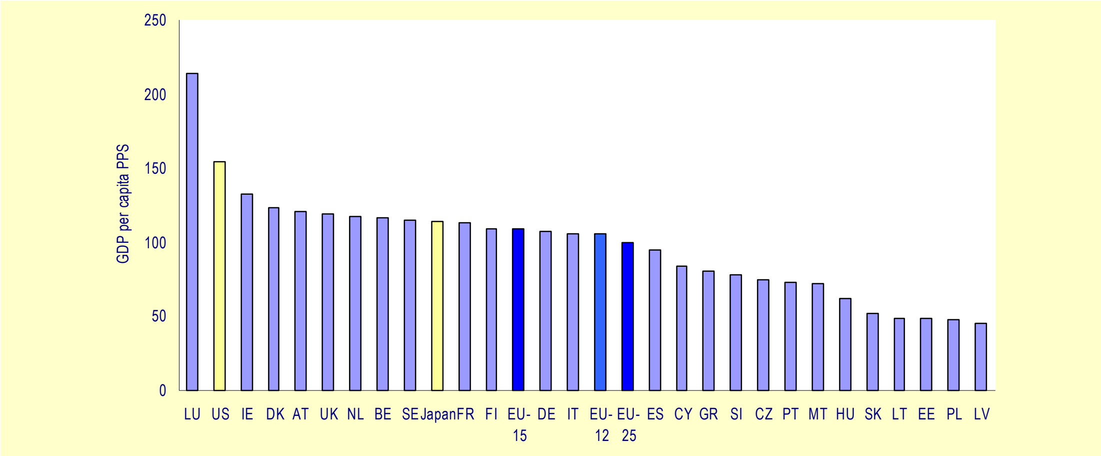
Country-specific recommendations were also addressed to two of the new Member States. In Estonia wage growth eased somewhat in 2004, and unit labour costs clearly decelerated, supported by stronger productivity growth, ensuring that wage developments were compatible with employment growth. Hungary was recommended to encourage a reform in wage setting and promote multi-annual agreements. While there were no systemic reforms, progress was made as regards wage moderation, helped by a slowing in public sector wage rises from the rapid pace of the preceding years.

2.2 Economic reforms to raise Europe's growth potential

Living standards in the EU remain well below those in the US …

Over the past three decades, living standards in the EU-15 (approximated by GDP per capita in purchasing power parities) appear to be stuck at around 70 per cent of the US level. Taking the new Member States into account, EU GDP per capita drops to 65 per cent of the US level. Graph 2.5 illustrates the still substantial differences in living standards between EU countries, with GDP per capita in Luxembourg exceeding that of the US and that in Poland and the Baltic States not yet reaching one third of the US level. However, the new Member States generally enjoy growth rates well above those of the former EU-15 Member States and contribute to an overall dynamism of the EU economy.

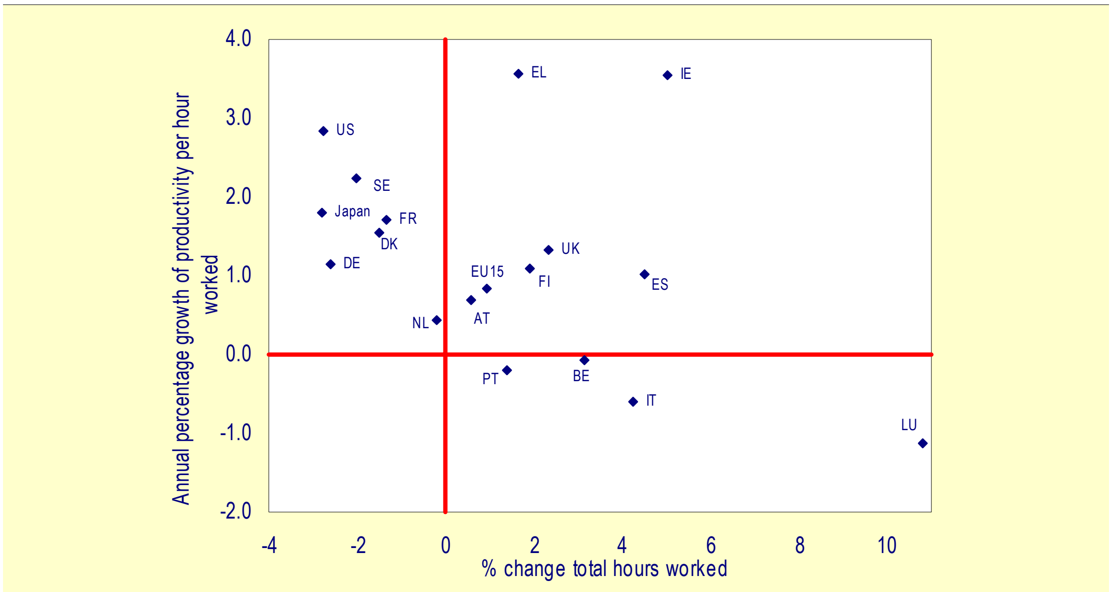
Graph 2.5: GDP per capita 2004 (EU-25=100)



Source: Commission services (Eurostat, structural indicators).

The increased contribution of employment to EU GDP growth since the mid 1990s has been offset by a reduction in the contribution from labour productivity. Over the period 2000-2003, the EU-15 increased both its labour productivity per hour worked (albeit by less than in previous years) and the total number of hours worked. This was not the case in Denmark, Germany, France, the Netherlands, Sweden, Japan and the US where the total number of hours worked declined.

Graph 2.6: Evolution of productivity and total hours worked (2000-2003)



Source: Commission services.

In Belgium, Portugal, Italy and Luxembourg on the other hand the number of hours increased, but hourly productivity declined. Currently, one third to one half of the differential in living standards between the EU and the US can be associated with differences in hourly productivity, while the remainder is related to a difference in the number of hours worked (including differences in the employment rate as well as the hours worked per worker).

The combination of a productivity slowdown and the low employment rate, against the background of the challenges stemming from globalisation and ageing, points to the need to vigorously pursue economic reforms. The recent report "Facing the Challenge" of the High Level Group on the Mid-Term Review of the Lisbon strategy reiterates this need.

Box 2: The Report of the High-Level Group on the Mid-Term Review of the Lisbon Strategy "Facing the Challenge"

The 2004 Spring European Council invited the Commission to establish a high-level group headed by the former Dutch Prime Minister Wim Kok, to prepare an independent contribution to the Mid-Term Review of the Lisbon Strategy to be held in the Spring of 2005. The mandate of this group was to identify the measures required to achieve the Lisbon goal and to assess the effectiveness of the instruments of governance.

The Group delivered its report in early November 2004. Its assessment is that while some progress has been made since Lisbon, the pace of reform needs to be significantly stepped up if the Lisbon goal is to be achieved. Slow implementation of the measures foreseen within the context of the Lisbon strategy have been at the heart of the problem. The report proposed refocusing the Lisbon strategy on a limited set of concrete reform measures, which should benefit from a supportive macroeconomic framework, with a view to stimulating growth and employment creation. It highlighted five traditional Lisbon areas with recommendations – namely the knowledge society, the internal market, the establishment of a favourable business climate, the creation of a more adaptable labour market and the promotion of leadership in eco-innovation. The 14 specific recommendations regarding these areas cover issues such as how to attract world class scientists and researchers, a European Research Council, adoption of the Community Patent, transposition of directives, integration of services and follow-up to the Financial Services Action Plan, reduction of administrative burden, reduction of time and cost to set-up business, implementation of the labour market recommendations of the European Employment Taskforce, national strategies for life-long learning, a comprehensive ageing strategy and greening of public procurement.

To make the Lisbon strategy a success, the Group proposes to increase ownership by introducing national action programmes in which Member States formulate their plans to achieve commonly agreed targets. As regards the BEPGs and Employment Guidelines, it recommends to adopt new guidelines for a period of four years by July 2005, reflecting the focused objectives of growth and employment. Finally, the report identifies a need to increase peer pressure on Member States and to improve the communication of the Lisbon project to European citizens.

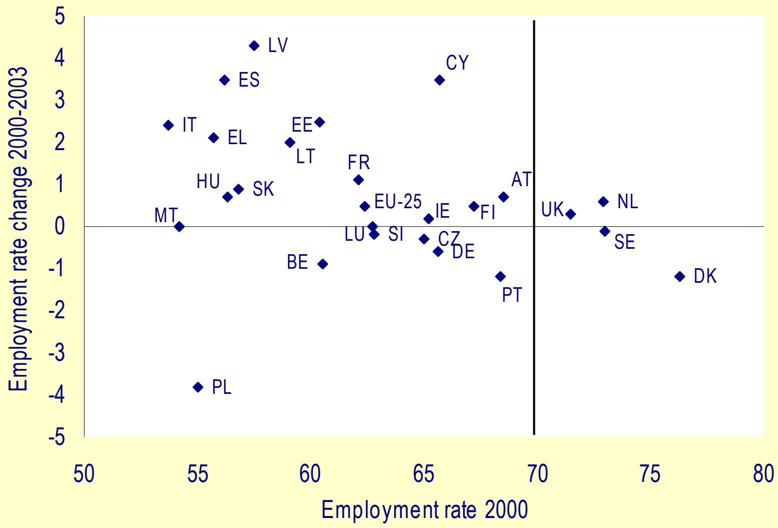
2.2.1 Halfway through the first decade of the Lisbon strategy, the EU is failing to reach the employment targets

The Lisbon and Stockholm employment targets now look markedly more challenging, if not unattainable, than they did in 2000

Employment growth has declined markedly in recent years, due *inter alia* to the previous economic slowdown. Although an economic recovery is now underway, its impact on the labour market is expected to remain relatively modest in 2004 and 2005 (with employment growth estimated at 0.4 per cent and 0.7 per cent in EU-25 respectively, according to the Commission's Autumn 2004 Economic Forecasts).

At the Member State level the development is diverse, with on the one hand, a relatively dynamic employment growth noted in e.g. Greece, Spain, Italy and the smaller new Member States since 2000. On the other hand, employment growth was relatively weak in most other countries and even turned negative in Belgium, Denmark, the Czech Republic, Germany, Portugal, Poland, Sweden and Slovenia during the period 2000-2003 (see Graph 2.7).

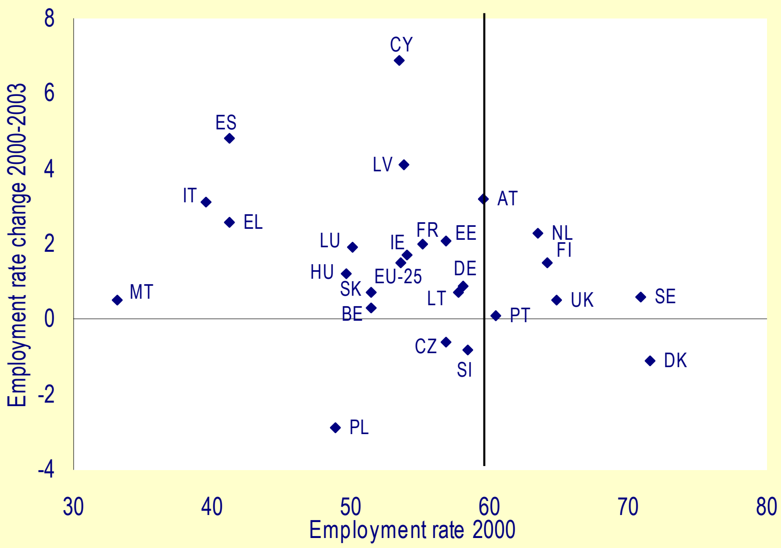
Graph 2.7: Total employment rate



Note: Lisbon target for total employment is to achieve 70% on average by 2010.
Source: Commission services (Eurostat, structural indicators).

In the 2000-2003 period, the overall employment rate for the EU-25 has increased by a total of 0.8 percentage points, bringing it to 62.9 per cent in 2003 on average (still far from the intermediate target of 67 per cent to be achieved by the end of 2005 or the '70 per cent' target by 2010). Differences are substantial across Member States, with employment rates ranging from 51.2 per cent in Poland to 75.1 per cent in Denmark in 2003, and with employment growth generally being slower in some of the larger Member States.

Graph 2.8: Female employment rate

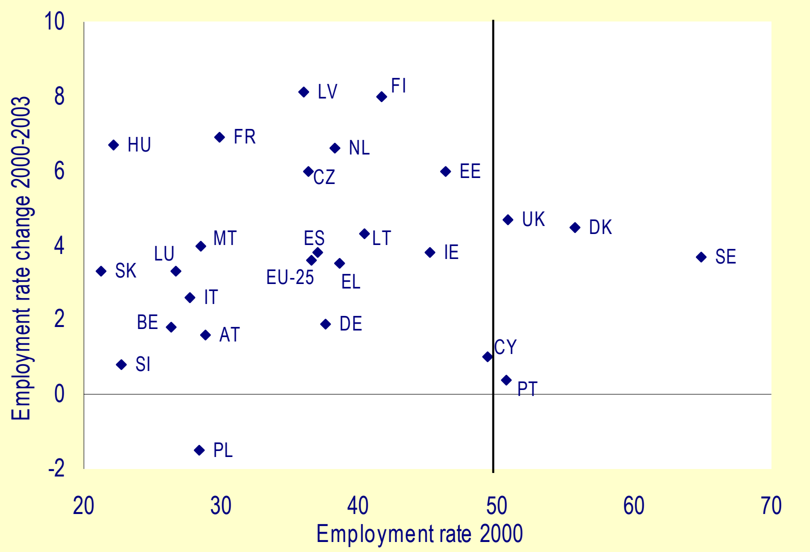


Note: Lisbon target for female employment is to achieve 60% on average by 2010.
Source: Commission services (Eurostat, structural indicators).

The female employment rate rose to 55.1 per cent on average in 2003 (varying from 33.6 per cent in Malta to 71.5 per cent in Sweden). The female employment rate also remains below the intermediate target of 57 per cent or the 60 per cent target to be achieved by 2010, although they appear still to be within reach. For instance, the female employment rate has risen almost twice as fast as the total employment rate (see Graph 2.8). The increase was particularly rapid in Cyprus, Spain, Greece, Italy, Latvia and Austria, reflecting both labour market reforms to dismantle barriers to female participation and cultural change. As mentioned in last year's Implementation Report, the overall development is also due to an age-cohort effect, as younger cohorts are more likely to participate in the labour market.

In contrast, the employment rate of older workers (aged 55-64), which amounted to 40.2 per cent in 2003 (ranging from 23.5 per cent in Slovenia to 68.6 per cent in Sweden), has the greatest distance to cover towards the 2010 target of 50 per cent.

Graph 2.9: Older workers employment rate



Note: Lisbon target for older workers employment is to achieve 50% on average by 2010.
Source: Commission services (Eurostat, structural indicators).

The unemployment rate for the EU-25 continued to increase somewhat in 2003 to 9.1 per cent and is expected to have stabilised around that level in 2004. By the last quarter of 2003, unemployment rates ranged from 3.9 per cent in Luxembourg to 19.2 per cent in Poland. Moreover, youth unemployment remains very high, over 18 per cent, while long-term unemployment is over 44 per cent of total unemployment in the EU-25.

Summing up, the employment targets look more challenging at mid-term than they did in 2000, when the EU-15 employment rate stood at 63.4 per cent and employment growth was strong. The macroeconomic slowdown can partly explain the disappointing performance over the past few years. The current economic recovery will help to move towards the targets, but the recovery of employment once growth picks up is expected to be modest. Some labour-hoarding appears to have been taking place during the economic slowdown, as suggested by a relatively low cyclical level of labour productivity recorded recently, which is likely to cause a subdued employment growth in the recovery. More importantly and up to 2001, there were signs that some structural reforms of product and labour markets, together with wage moderation, were beginning to pay off. Thereafter progress in labour market reforms seemed to have levelled off. Without a swift implementation of comprehensive labour market reforms the Union will fail to reach the Lisbon and

Stockholm employment rates targets by 2010, except possibly for female employment rates.

> Against this background, the 2003-05 BEPGs recommended Member States to:
>
> 4. improve the combined incentive effects of taxes and benefits and reduce high marginal effective tax rates;
> 5. ensure that wage bargaining systems allow wages to reflect productivity differences;
> 6. review labour market regulation and promote more adaptable and innovative work organisation;
> 7. facilitate labour mobility;
> 8. ensure efficient active labour market policies.

Overall, the pace of labour market reforms needs to accelerate, if the Lisbon targets are not to be missed by a large margin

In general, the pace of reforms on the labour market has improved slightly since 2003. This follows, above all, from the recent measures adopted and/or proposed in Germany as well as from significant progress in Denmark, the Netherlands, Ireland and Austria. However, several Member States are still in the process of adopting reforms. Overall, reform efforts have concentrated in the areas of labour tax cuts, active labour market policies and strategies for lifelong learning, while fewer measures were taken in the areas of wage bargaining, benefit systems and employment protection legislation (in particular permanent contracts) which would influence labour participation and unemployment more.[8]

Tax and benefit reforms continue: Member States tend to start reforms by reducing labour taxes, but few countries are taking measures to reform unemployment and related benefit schemes

Improving incentives to work, particularly in the design of unemployment and related benefit schemes, remains a serious challenge in most Member States. Indeed, recommendations to address disincentives to work were given to 18 Member States.

In general, measures adopted or announced in 2003 focused on reducing taxes with little action to reform benefit systems, although it is the combined effect of taxes and benefits that contributes to the risk of unemployment and inactivity traps. Several Member States adopted tax reforms to increase the incentives to enter or stay in the labour market, primarily for low wage earners, even if these measures are relatively costly to public finances.

In 2004, Germany, France and the Netherlands took measures to lower the duration of unemployment benefits, combined with stricter eligibility conditions and job-search requirements. Denmark also tightened job availability criteria. Portugal amended the sickness benefit system to eliminate disincentives to work. Sweden implemented measures to raise the levels of certain social insurance benefits, while

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8 In box 2 in Annex 1, the main reform measures undertaken in 2003 and 2004 in response to guidelines 4-8 are summarised by Member State.

tightening the enforcement rules related to sickness insurance. Finland announced mandatory participation in active measures to receive unemployment benefits.

In the new Member States, there is a widespread need to lower the tax burden on labour, especially at the lower end of the wage scale. Ambitious efforts are needed to redesign benefit systems with a view to making the transition from welfare to work easier. In practice, this is a considerable challenge given the heavy reliance of certain groups of the population on social assistance as their primary source of income. Introducing in-work benefits might be usefully considered, although these policies tend to have a high fiscal cost. Hungary has started to reduce labour taxes and to reform healthcare contributions, and Slovakia adopted measures regarding social assistance. The Czech Republic has taken action in reforming its unemployment benefit systems, by increasing the level of benefits while introducing more stringent conditions of eligibility and work availability requirements. Furthermore, it has cut the sickness benefit system while rendering enforcement stricter. Slovakia introduced benefits to increase work incentives. Slovenia enacted its tax reform to reduce labour costs and in particular the burden on lowest wages.

Very little has been done to ensure that wages better reflect productivity and local labour market conditions

In the context of a monetary union and with large regional disparities within several Member States, as well as strong differences in unemployment across skills, 12 Member States were specifically recommended to allow for a greater wage differentiation to better reflect productivity differences across industries, regions and skills. Public sector wage settlements may also play an important role in a number of countries.

Last year's Implementation Report highlighted an informal trend towards more flexibility at the firm level, as variable forms of pay, related to individual achievements and to the situation of the company, are becoming more widespread. In many new Member States, wage negotiations at firm level predominate.

In 2004, the most noticeable measures focused on minimum wages. The introduction of a statutory minimum wage is being discussed in Germany while a minimum wage for 15-17 year-old was introduced in the United Kingdom. In Spain the minimum wage was increased and in Finland the government proposed making tax cuts conditional on a moderate wage settlement. National minimum-wages, if high relative to average wages, tend to compress the wage distribution and could price workers out of the labour market. In Germany, the government has encouraged social partners to make greater use of opening clauses in collective agreements.

In some Member States, work organisation is becoming more adaptable; however very few initiatives in employment protection legislation are taken to foster job creation

A flexible regulatory framework and work organisation is necessary to support change and facilitate adjustment. In 2003, Germany, Greece, Spain and Italy started to take action to respond to recommendations received. In 2004, Germany started to reverse the trend of reduced working time in specific branches.

France amended the redundancy legislation to loosen employment protection and Germany also increased fixed-term contract duration and loosened employment protection legislation for small firms by raising the threshold to apply provisions against dismissal from 5 to 10 employees. However, no other Member State has taken significant action to tackle "overly strict" employment protection legislation, nor to reduce the segmentation of the labour market across different types of contracts. The activation of more flexible labour contracts in Italy may actually increase segmentation of the labour market.

Some Member States are encouraging geographical mobility, and the majority are promoting occupational mobility

Regional disparities in several Member States, often with simultaneous unemployment and skills shortages, continue to point to the need to foster geographical and occupational mobility. A recommendation to eliminate barriers to geographical mobility was addressed to Spain.

Insufficient wage differentiation or some features of the non-employment benefit systems also appear to be inhibiting geographic labour mobility by providing incentives for the unemployed to remain in rural areas. In 2003, some Member States introduced changes in the tax/benefit system, in order to improve incentives to mobility (i.e. Germany, Greece, Spain, France and Sweden. Spain continued to address rigidities in the housing market. A majority of Member States continued to foster occupational mobility e.g. through lifelong learning programmes. Indeed, participation rates in lifelong learning in the EU-25 have seen a steady increase since 2001 (7.9 per cent) to the current level of 9 per cent (2003); however, it remains particularly low in many Member States, (notably in the Czech Republic, Greece, Italy, Malta, Portugal and Slovakia) and varies widely according to age and attainment level.

In 2004, the dissemination of information on vacancies continued to improve through the cooperation of Member States and the use of information technology, notably through the development of a European Job Mobility Portal (EURES).

Some Member States have taken measures in the area of labour market policies to favour labour market participation; but the redesign of policies following their evaluation remains exceptional

The role of both incentives and targeting of active labour market policies (ALMPs) has been highlighted by many countries to improve their efficiency. Germany received a specific recommendation to increase the efficiency of ALMPs.

In 2004, Germany stepped up its evaluation effort, as public employment services defined performance targets for local offices and intend to control their placement performance regularly. Moreover, ALMPs in general no longer lead to re-qualification for unemployment benefits. Finally, the design of individual action plans will become mandatory and some programmes will be discontinued in 2005 following poor results of an evaluation. Denmark and the Czech Republic have taken action to target ALMPs to specific groups. The Netherlands is strengthening the evaluation through development of performance-based ALMPs while Greece and Finland have improved their public employment services.

2.2.2 Addressing the underlying causes of the slowdown in EU labour productivity growth

Hourly labour productivity growth in the EU has fallen behind …

For the first time in decades hourly labour productivity in the EU-15 is on a trend growth path which is lower than that of the US. This productivity slowdown has culminated into negative growth rates in 2003 for Italy, the Netherlands and Portugal. For most of the new Member States no data on hourly productivity are currently available in the Structural Indicators. Nevertheless, since 1996 growth in labour productivity per person employed in the new Member States overall has consistently been above that of the former EU-15 Member States. However, even among the new Member States country performances may differ substantially. In 2004, labour productivity growth varied from less than one per cent in Malta to more than 5 per cent in Lithuania, Latvia and Poland.

… due to a lack of investment and a slowdown of technological progress

The slowdown in EU labour productivity growth rates since the mid-1990s can be attributed in equal parts to a lower investment per employee and a slowdown in the rate of technological progress. The former can be partially explained by a higher rate of job creation, as those who enter employment from either unemployment or inactivity have below-average productivity. However, this explains only 30 per cent of the productivity slowdown. The latter has been associated with (1) the difficulty of the EU in reorienting its specialisation towards sectors with high productivity growth prospects; (2) the poorer productivity performance and smaller size of ICT producing industries (including office equipment and semiconductors) in comparison with the US; and (3) the lower productivity growth than the US in ICT using services (such as wholesale and retail trade, financial services) due to a slower diffusion of new, more knowledge based, technologies.

Product market reforms may result in substantial productivity gains …

Additional product market reforms are required in order to transform the EU into a more competitive and dynamic economy. This can be achieved by improving the framework conditions in which business operates. Beyond the direct impact of a decrease in the costs of doing business, well-designed product market reforms can indirectly contribute to increasing productivity by creating incentives for a reallocation of resources within and amongst firms and sectors towards more productive activities and by stimulating innovation and the use of new technologies. Research shows that reforms facilitating market entry and raising the level of competition on goods and services markets may result in substantial productivity gains.[9] Productivity gains tend to be concentrated in high–tech sectors and it is in these sectors that new firms make the most significant contribution to productivity growth. The provision of high quality scientific, technical and managerial education is essential to the development and diffusion of innovative production technologies.

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[9] European Commission (2004), "The link between product market reforms and productivity: Direct and indirect impacts", Chapter 5 in The EU Economy 2004 Review, European Economy

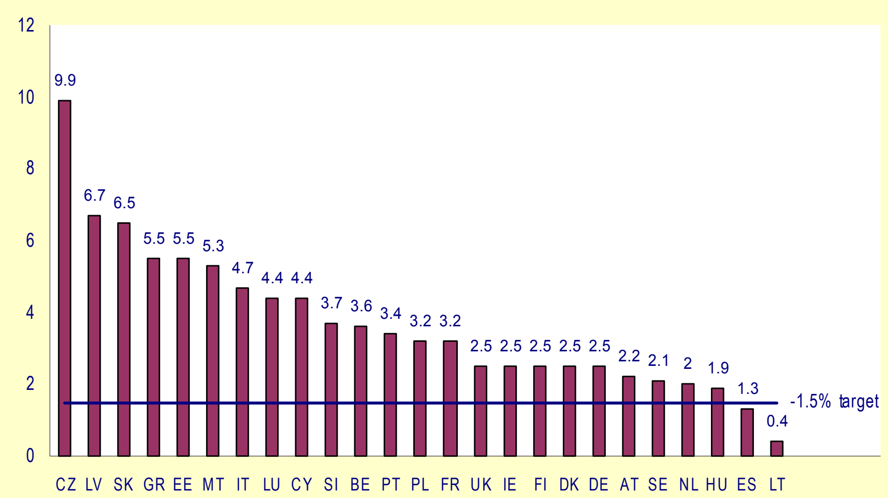
Against this background, the 2003-05 BEPGs recommended Member States to:

9. foster competition in goods and services markets;
10. accelerate the integration of EU capital markets, by *inter alia* ensuring consistent enforcement of EU rules and removing barriers to efficient cross border clearing and settlement;
11. generate a supportive environment for entrepreneurship and for SMEs to start-up and grow;
12. agree on and implement measures to strengthen corporate governance and further improve arrangements at national and Community level to deliver efficient cross-sector and cross-border cooperation in financial supervision and financial crisis management;
13. take active steps to promote investment in knowledge, new technologies and innovation and make progress towards the 3 per cent of GDP objective to total R&D investment by *inter alia* developing framework conditions conducive to R&D and innovation, promoting access and use of ICT and improving the quality and efficiency of education and training systems;
14. enhance the contribution of the public sector to growth by *inter alia* redirecting public expenditure and increasing the efficiency of the public sector.

…but the pace of Internal Market integration appears to have slowed down

In order to make the EU economy more competitive and dynamic it is essential to ensure that the Internal Market is well-functioning and undistorted by sectoral and ad hoc State Aid. However, many indicators point towards a slowdown in EU product market integration. Partly as a consequence of slower economic growth, trade amongst the EU-15 Member States has stalled, growing only 0.6 per cent in 2002 and then shrinking 0.3 per cent in 2003.

Graph 2.10: Transposition deficits (percentage of directives not notified), November 2004



Source: Commission services.

These figures are little different from developments in extra-EU trade, even when there are signs that intra euro area trade has developed more favourably. Moreover, following years of strong convergence, price dispersion across the EU as a whole (as measured by the coefficient of variation of consumer price levels) has stabilised at 29 per cent. For comparison, the coefficient of price variation in the euro area is 14 per cent.

Even though some former EU-15 Member States (Austria, Germany, France and the Netherlands) have made progress in transposing the Community's Internal Market directives into national law, only Spain managed to keep or bring the implementation gap below the Lisbon strategy target of 1.5 per cent, which had been set initially for March 2002. For the former EU-15 Member States taken together, the progress achieved in closing the gap during the first years of Lisbon (from 3 per cent in 2000 to 2 per cent in 2001) has been reversed as transposition in the last two years has been extremely sluggish. In fact the EU-15 transposition deficit returned to 3 per cent in November 2004. For the new Member States, reaching the 1.5 per cent target posed an even greater challenge. Lithuania, however, has delivered an outstanding performance by bringing the transposition deficit down to 0.4 per cent in November 2004.

The number of infringement cases against Member States also remains at an unsatisfactorily high level. The value of public procurement that is openly advertised continues to increase, but still accounts for only 16 per cent of the total value of public procurement. It is clear from persistent differences between Member States in the value of openly advertised public procurement as a percentage of GDP that there is considerable scope for further improvements particularly in Germany, Italy, Luxembourg, Austria and Finland. The public procurement legislative package was adopted by Parliament and Council in early 2004. In Spain, Finland and Sweden committees were set up to improve public procurement practices.

The elimination of tax related obstacles to cross-border activities …

The results of a recent survey of over 700 European companies show large tax obstacles to cross-border activities. Companies with subsidiaries or permanent establishments in another Member State face significantly higher tax compliance costs than companies with domestic subsidiaries only. Especially for small and medium-sized companies this is an important trade barrier as the costs of complying with VAT and corporate tax requirements have been estimated to represent 1.9 per cent of tax collected for large companies and 30.9 per cent of tax collected for SMEs. In 2004, a number of directives related to company taxation and VAT rules were adapted, which if properly implemented should contribute to a better functioning Internal Market. Although there is evidence of corporate tax competition amongst some countries with similar characteristics (such as the Baltic States), there is no evidence of a general race to the bottom. The new Member States have generally lower statutory rates but their level of effectively paid taxes is not very different from that in the EU-15 countries. Finally, the level of State aid (excluding aid to agriculture, fisheries and transport) in the EU-15 appears to have stabilised at 0.4 per cent of GDP. For the ten new Member States as a whole, such State aid was significantly higher amounting to 1.4 per cent of GDP over the period 2000-2003. However, the average conceals wide variations between the new Member States, ranging from 0.1 per cent in Estonia to 3.9 per cent in Malta. Furthermore, if certain measures which are in the process of being phased out are excluded, the average for the new Member states drops to 0.7 per cent. The State aid given in most new Member States (in e.g. Poland and Malta) is still largely sectoral in nature.

… and the creation of an Internal Market for Services carry important benefits …

The proposed directive on the Internal Market for Services foresees the free movement of services by ensuring that service providers only have to comply with the national law of their home country when they want to provide their services across borders on a temporary basis (eliminating the requirement to set up shop in the Member State concerned). Opening up trade and cross-border activities in services would have a considerable impact on growth because of the large and growing share of this sector in the economy. A recent study[10] estimates that adoption of the Service Directive would raise the GDP level by 0.6-0.7 per cent.

… as does the liberalisation of network industries provided that effective competition is ensured

Market opening in the network industries continues to progress leading, in general, to productivity gains and price reductions. In 2004, further steps towards a full liberalisation of the energy market were taken in the Flanders region of Belgium, Denmark, France, Ireland, Italy, Luxembourg, the Netherlands and Portugal. In many new Member States the framework for competition in network markets is also increasingly well-developed, as their economies have been opened up to international competition. However, this process does not necessarily guarantee effective competition. Many Member States have yet to communicate the national measures required for the transposition of the two energy directives. The effective implementation of these directives and improved cross-border transmission networks are essential conditions for the creation of a single energy market. The target of 10% of import capacity compared to the installed generation capacity will not be achieved in 2005 by Italy, Spain, Ireland and United Kingdom. Portugal and Greece will only reach the target in 2005 if the projects under construction are completed on time. Latvia and Lithuania have initiated efforts to improve interconnections with European networks and the creation of an Iberian electricity market in June 2005 has been announced.

In liberalised markets, the market share of the incumbent remains high. In fixed telephony, for example, the market share of the incumbent in the former EU15 Member States was 77 per cent for local calls, 67 per cent for long-distance calls and 60 per cent for international calls in 2003. With the implementation of the new regulatory framework, competition in the e-communications services sector is nevertheless intensifying in most markets, bringing increased benefits to consumers. Prices of long distance and international calls, for example, have continued to decline. However, at the end of 2004 five Member States had not yet notified measures transposing the regulatory framework for electronic communications.

Rail freight market opening began in March 2003 on the majority of the international lines. However, Community legislation in this domain is not yet fully implemented by all Member States and a number of rail companies still need to be restructured. Effective competition in the rail freight market only exists in Denmark, Germany, Italy, Netherlands, Sweden and the United Kingdom.

[10] Copenhagen Economics (2004), "Economic Assessment of the Barriers to the Internal Market for Services", study commissioned by the Enterprise Directorate General of the European Commission.

Competition policy has been modernised

The entry into force of the "Modernisation Package" for the enforcement of the Community antitrust rules on 1 May 2004 will enhance the effectiveness of competition policy by clarifying rules and streamlining procedures. The Commission's powers of investigation and the penalties for anticompetitive behaviour have been strengthened. More responsibility has been devolved to national competition authorities and courts, since many cases may be more effectively dealt with at the national level, but a system has been put in place to ensure a consistent approach is adopted at the Community and national levels. Over the past year Ireland, the Netherlands, Spain and the United Kingdom have significantly increased the resources (staff and budget) of their competition authorities. While the new Member States have made encouraging headway in strengthening competition rules and establishing independent competition and regulatory authorities, there is still some way to go.

Denmark has stepped up its efforts to strengthen competition in certain sectors where it was still inadequate, but progress in countries such as Spain, Ireland, Finland and Sweden was more limited.

The Risk Capital Action Plan has delivered positive results…

The Risk Capital Action Plan (RCAP) was launched in 1998 with the objective of eliminating barriers impeding the creation of an integrated single market in risk capital by 2003. In this period of five years, considerable progress has been made, with all political as well as many technical objectives attained. The European risk capital industry is now much larger, more mature and professional than before the RCAP was launched. The European risk capital markets can now be considered strong as far as the buy-out segment is concerned, but venture capital in early stage investment still requires attention.

Box 3: Progress in developing the risk capital market

In November 2003, on the occasion of the discussion on the final RCAP progress report, the Ecofin Council requested to be informed about the progress in developing the risk capital market "in the context of the annual Commission report to the Spring European Council".

In 2004, the Commission made further steps in support of the development of the European risk capital market.

Firstly, in view of the possible implications of the proposed re-cast capital adequacy requirements for banks and investment firms, the Commission presented a proposal fully taking into account of the concerns of risk capital providers. The proposal acknowledges the benefits from diversification inherent in venture capital and private equity funds and proposes accordingly lower capital requirements. The implications of the implementation of the International Accounting Standards (IAS) on risk capital providers are also being assessed.

Secondly, in the context of identifying possible obstacles for investments by institutional investors (pension funds) in venture capital funds, research done by the Commission services showed clear differences in the profitability of venture capital investment in Europe and the US. The lower European profitability than in the US venture capital industry is particularly notable in the case of early stage investing.

Thirdly, the Commission is preparing a proposal for the successor programme for the Multi-Annual Programme (MAP) for Enterprise and Entrepreneurship containing also Community financial support for investments into early stage SMEs and innovative as well as high growth potential companies in their expansion phase. The measures of the new programme will aim to support innovation and enterprise competitiveness.

Furthermore it should be noted that the Commission Communication on State Aid and Risk Capital is in the process of being evaluated as to the appropriateness of state aid rules in relation to early stage venture capital investment. A revised communication is scheduled to be presented in 2005.

…and the Financial Services Action Plan nears completion

By the end of 2004, the legislative phase of the Financial Services Action Plan (FSAP), aimed at completing the internal market for financial services, was nearly completed. Of the 42 original legislative and non-legislative measures, 39 have now been adopted at EU level. Two of the three remaining measures (the third Capital Adequacy Directive and the 10th Company Law Directive on cross-border mergers) are under discussion in the Council and the Parliament, while a proposal for the third measure (14th Company Law Directive on transfer of seats) is under preparation. Of the FSAP measures already adopted, 23 are directives that have to be transposed into national laws. The deadline for full transposition has passed for 13 of them and infringement procedures have been launched in some cases. The rate of transposition has varied by directive and by Member State. Some of the early FSAP directives are close to full transposition, while the directives with the greatest problems in terms of transposition include those relating to the reorganisation and winding-up of insurance undertakings and money laundering. Overall, the transposition rate of the directives has been sufficient, with some countries (notably Denmark, Italy and Austria) doing relatively well.

Special mention should be made of the efforts made in the new Member States in the area of regulatory reform of the financial sector. These Member States were required to adopt the EU-acquis before 1 May 2004: almost full compliance was achieved in respect of the free movement of capital and company law, while some of these Member States have retained specific transitional arrangements in relation to the freedom to provide financial services. It should be noted that many of the new Member States have also worked very hard to ensure timely transposition of FSAP Directives.

With the FSAP near completion, the focus is now turning to the next phase of EU financial integration. The Commission has launched a wide consultation exercise to take stock of the progress made in financial integration and to identify remaining gaps. Meanwhile, the Council has provided an indication of its priorities for the next phase of financial integration. Alongside the input from the Council and the recommendations made by the High-Level Group on the Mid-Term Review of the Lisbon strategy (the so called Kok Group), it will help the Commission in the choice of priorities for the future it is to present in the first half of 2005.

Clearing and settlement systems are still to become better integrated…

In line with the high priority assigned to improving clearing and settlement in the EU, the Commission issued a Communication in May 2004, presenting proposals on how to foster an integrated, safe and efficient post-trading environment for EU securities markets. Further to it, a high level group of experts[11] has been established

[11] So called CESAME Group, which stands for Clearing and Settlement Advisory and Monitoring Expert group.

to advise the Commission and to coordinate action by the private sector on removing the so-called Giovannini barriers for which the private sector would bear responsibility. Meanwhile, further initiatives were taken in 2004 by Member States which should improve the effectiveness of their clearing system (Italy) and settlement systems (improvement of operations on the dematerialised securities system (Greece), introduction of a new electronic settlement system (Italy) and a new securities register (Poland), efforts to establish a central securities depositories (CSD) (Czech Republic and Slovakia), as well as open their systems to outside links (Slovenia). In addition, consolidation among EU clearing and settlement providers has continued in 2004 with the merger of the Swedish and Finnish CSDs.

…while various targeted domestic measures have been taken to improve markets' efficiency

These measures have been complemented by various Member States initiatives to increase the efficiency of their financial sectors. Measures have been taken for instance to support financial innovation (e.g. measures to support the development of hedge funds, mortgage bond or commercial paper issuance (France, Germany), facilitate securitisation (France, Germany, Luxembourg), and reform savings schemes (Czech Republic, France)); to improve competition (measures to abolish banks' monopoly in accepting deposits and new legal framework for covered bonds (Sweden), and to improve efficiency (rationalisation of the stock exchange (Cyprus), launch of its privatisation process (Poland), gradual withdrawal of illiquid securities from the stock market and relicensing of securities brokers (Slovakia)). However, further reforms are necessary, particularly in several of the less-developed financial sectors of the new Member States.

Business investment has suffered a cyclical decline and …

Recent developments in business investment seem to indicate that the environment for enterprises has not improved as business investment declined from 18.4 per cent of GDP in 2000 to 16.8 per cent in 2003. Due to the economic catching-up and inflows of FDI (foreign direct investment) the level of business investment in 2003 was marginally higher in the new Member States. Those countries also experienced lower declines over the period 2000-2003 with Estonia, Latvia and Slovakia even increasing their levels of business investment.

This was the case as well in Greece, even though 2003 inflows of FDI were relatively limited (0.3 per cent of GDP). The 2004 update of the BEPGs emphasized that for the new Member States sustaining a high level of FDI is an essential element of the transition towards higher value-added activities, as it encourages knowledge and technology diffusion. In 2003, FDI inflows as a percentage of GDP were relatively high in Cyprus (6.6 per cent), Estonia (9.9 per cent) and Malta (7.9 per cent).

… regulatory reform can contribute to its recovery

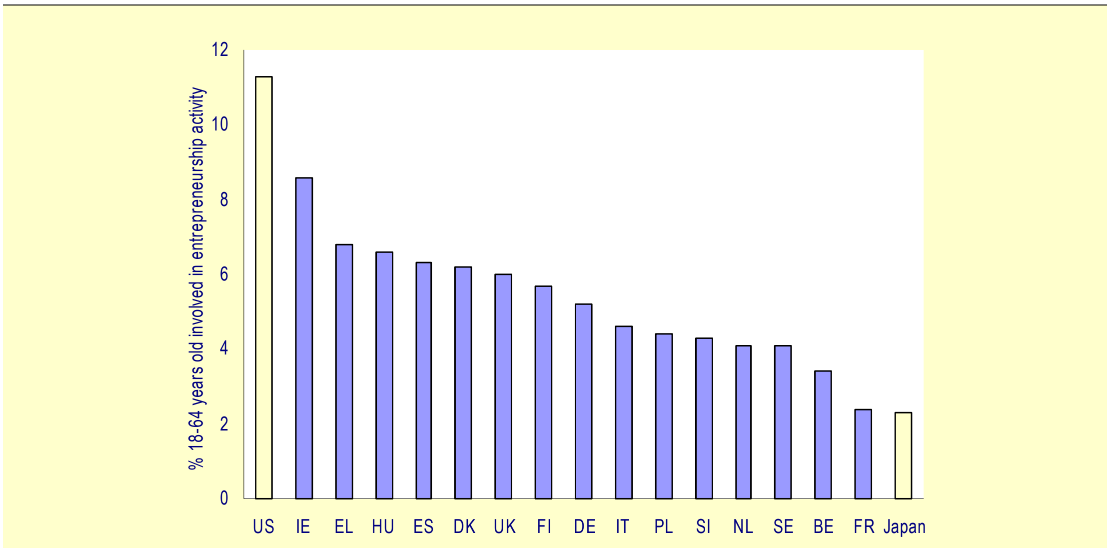
The purpose of regulation is to correct market failures and/or to protect the interests of individuals, businesses, government and society as a whole. Labour and environmental regulations, for example, are important to protect consumers and vulnerable social and economic groups and preserve the environment. Nevertheless, the cumulative impact of such regulations may impose substantial economic costs, at least in the short-run. In order to avoid too high a regulatory burden on business, it is essential that regulations are well-designed and proportionate.

The 4 Presidencies' Initiative[12] has made regulatory reform a priority over the course of 2004-2005. The Initiative is aimed in particular at simplifying regulations and reducing the administrative burden on business. The Commission and the European Council are supporting the development of a common approach to measuring administrative burden, which could be used to assess the national and Community regulations.

Business framework conditions appear to be improving

Economic regulations that act as a barrier to market entry can be especially damaging. The observation that it is easier to start a new business in the US than in most EU Member States (even if the situation has improved markedly over recent years) is particularly relevant in this respect. IN the US, entrepreneurial activity is more dynamic than in the EU.

Graph 2.11: Total entrepreneurial activity 2003



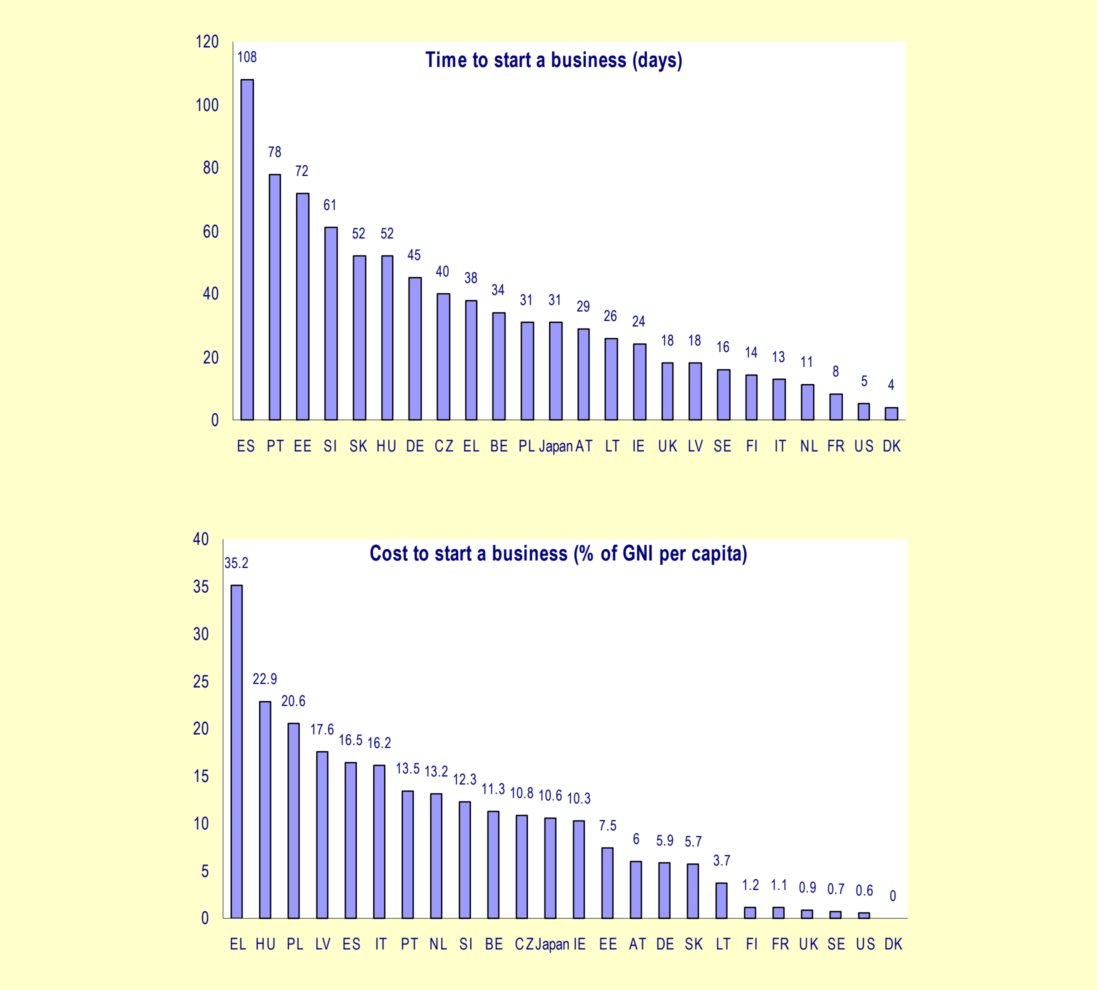
Source: Global entrepreneurship monitor 2003.

According to the World Bank, it takes 5 days to start a business in the US, while in the EU it takes an average of 36 days. However, business framework conditions in the EU appear to be improving as governments (in countries such as Belgium, France, Hungary, Poland and Slovakia) are making an effort to reduce the time and costs required for setting up a company, to streamline corporate taxation and to provide services via the internet. A recent study identifies the Nordic countries as leaders in e-government with e.g. Italy and Portugal lagging behind. [13]

[12] On 26 January 2004, the Irish, Dutch, Luxembourg and UK presidencies launched a Joint Initiative on Regulatory Reform with a letter from their finance ministers: http://www.finance.gov.ie/documents/pressreleases/2004/janmcc12462.pdf .

[13] Accenture (2004), "E-government Leadership: High Performance, Maximum Value", May.

Graph 2.12: Business start-up conditions in 2004



Source: World Bank, 2004.

Further steps made to strengthen corporate governance…

Several corporate scandals in the last few years have underlined the need to have clear and appropriate corporate governance arrangements both at national and at EU level. After the publication of the Action Plan on Corporate Governance in 2003, the Commission has taken several initiatives in 2004:

1. Adoption of recommendations on the role of (independent) non-executive or supervisory directors in listed companies and on the remuneration of directors;

2. Launch of a public consultation on the issue of shareholder rights;

3. Adoption of a proposal for a directive to modernise statutory audit within the EU, introducing new requirements on how audits are conducted and on the structures needed to ensure audit quality and trust in the audit function;

4. Proposals for revisions to Directives to establish collective board responsibility for financial and key non-financial statements and to enhance overall transparency in financial reporting;

5. Creation of a European Corporate Governance Forum to encourage the co-ordination and convergence of national codes. The Forum will meet for the first time in early 2005.

Member States have also taken further steps to strengthen their corporate governance arrangements. Among these initiatives are measures to improve the general standards for corporate governance and transparency (Czech Republic, Spain, Ireland, Cyprus) as well as more targeted measures focusing on investor protection and independence of supervisory boards members and/or auditors (Germany, France, the Netherlands, Poland).

…and financial supervision

Reflecting the progressive blurring of activities conducted by various sectors of the financial system, several Member States continued to improve cross-sectoral arrangements for supervision. In 2004, the Czech Republic and Slovakia began vesting all competences for supervision of financial markets and institutions in a single authority, in line with the model already adopted in 10 of the other Member States[14]. The Netherlands has carried on with the adoption of the legislative framework necessary for its new cross-sectoral functional supervisory model (one institution responsible for macro- and micro-prudential supervision, one responsible for all conduct-of business supervision). Belgium has merged its banking and insurance supervisors, while an advisory Financial Services Authority Supervisory Board was set up in March 2004. In Portugal, the National Council of Financial Supervisors extended its responsibilities with respect to cross-sector cooperation. In Cyprus, the Memorandum of Understanding between the banking, securities and insurance supervisors was extended to the supervisor of co-operative societies. France has carried on with the streamlining of its sectoral supervisory system. Several Member States (Greece, Germany and Sweden) have strengthened their supervisory arrangements in respect of the insurance and re-insurance sectors, including with respect to improved cross-border cooperation (Poland).

Further progress was made in cross-border supervisory co-operation, with the signature of a cooperation agreement between the Bank of Lithuania and the Swedish Financial Supervisory Authority, the strengthening of common Nordic supervision, and the signature of cross-border cooperation agreements between the Austrian Financial Markets Authority and its Slovak and Czech counterparts. In addition, both the Slovenian Securities Market Agency and the Hungarian Supervisory Authority have concluded co-operation agreements with several of their counterparts. Significant steps were taken at EU level, in particular the extension to all financial sectors of the so-called Lamfalussy approach.

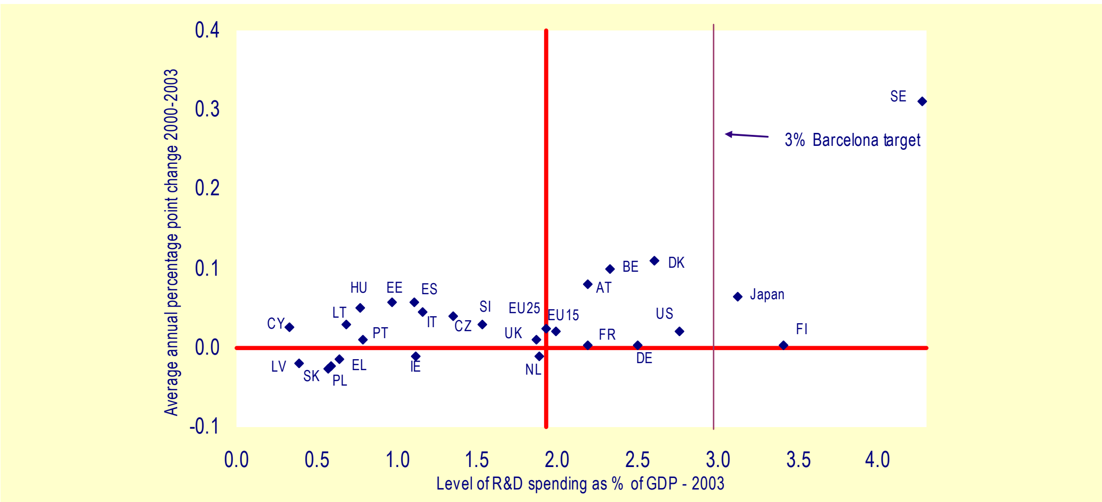
[14] The 10 Member States concerned are Denmark, Germany, Estonia, Ireland, Latvia, Hungary, Malta, Austria, Sweden and the United Kingdom. Arrangements are not strictly uniform, as major differences remain among these countries in terms of relationship with the central bank and in-house organisation

A widening gap between the EU and the US in terms of R&D and innovation …

There remains a substantial gap between the EU and the US in terms of innovative capacity as measured by R&D spending, the number of patent applications, venture capital and IT expenditures. Since 1999, R&D expenditures in the EU-15 Member States increased only marginally, only approaching 2 per cent of GDP in 2002, which makes the Barcelona target of 3 per cent virtually impossible to meet. Greece, Ireland and the Netherlands, however, have even recorded a decline in R&D spending since 1999. In Sweden and Finland, on the other hand, R&D expenditures as a percentage of GDP remain above that in the US. Since the Barcelona summit nearly all Member States have adopted national targets for increased public and private investment in research. In response to the 2003-2005 BEPGs Greece, Spain, Ireland, the Netherlands, Austria and Portugal have taken measures to improve the framework conditions for business investment in R&D and innovation, but progress in Italy has been more limited. The new Member States spend less on R&D (0.8 per cent of GDP) than the EU-15 members, but may make up for this disadvantage by benefiting from knowledge diffusion through FDI or innovation networks.

Several factors appear to have played a role in the widening gap between the EU and the US in R&D and innovation: a shortage of government and EU funds for research and postgraduate education, which moreover is very dispersed across the different fields; a fragmented, less competitive and less than stimulating environment for researchers; an insufficient focus on excellence in research and education; a lack of mobility of researchers, and insufficiently attractive European career perspectives for researchers; insufficient industry-science links; the absence of an affordable and legally-certain Community patent; and a relative shortage of risk capital in the euro area. All these factors make the US a more attractive place to do research.

Graph 2.13: Evolution of R&D spending 2000-2003 (or latest available period)



Source: Commission services (Eurostat, structural indicators).

…but rapidly rising Internet access and use

The e-Europe action plan has been instrumental in raising Internet access and use. The percentage of EU households with internet access at home rose from 18 per cent in 2000 to 41 per cent in 2003 with Denmark, the Netherlands and the United

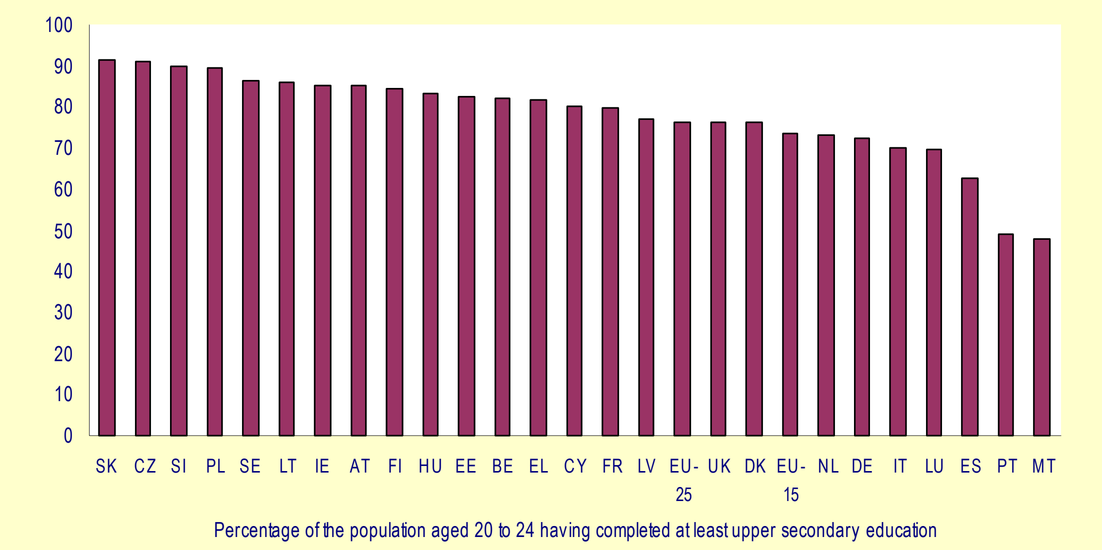
Kingdom leading the ranking and Greece, Spain and Portugal being at the bottom. Moreover, 87 per cent of enterprises with more than 9 employees had Internet access in 2003, which was a 17 percentage point increase over the last two years. Similarly, broadband internet access per 100 inhabitants has increased significantly, reaching 6.0 per cent in 2004. This is, however, still less than in the US which recorded 8.7 per cent. Amongst EU Member States, the highest access rates were recorded in Belgium, Denmark, the Netherlands, Finland and Sweden.

Mixed messages on education and training

The latest statistics for 2001 indicate a slight increase in public spending on education and training in the EU, but levels vary significantly between countries (from over 7 per cent of GDP in Denmark and Sweden to under 4 per cent in Greece and Luxembourg). Private spending is important in only a few Member States (Germany in particular), and overall it is low compared to that in the US and Japan.

When looking at rates of participation in education and training, a somewhat more positive message emerges. Adult participation in lifelong learning has seen a steady increase since 2001 (7.9 per cent) to the current level of 9 per cent. Nevertheless, the 2010 objective of achieving a 12.5 per cent rate of adult participation remains difficult to achieve. Moreover, participation remains low in many Member States (the Czech Republic, Greece, Italy, Lithuania, Malta, Portugal, Slovakia), varying widely by age and attainment level. The target set for the EU for 2010 that 85 per cent of 22 year olds should have completed upper secondary level education also represents a major challenge. The EU average (76.7 per cent in 2003) has hardly progressed since 2000 and wide disparities exist between Member States (see Graph 2.14). Women generally have higher attainment levels than men.

Graph 2.14: Youth education attainment level (2004)



Source: Eurostat.

Despite recognition of the importance of reducing the number of early school leavers, action is often piecemeal. Most policies consist of special measures to support the most vulnerable students outside the mainstream education system. The proportion of early school leavers decreased slightly to 16 per cent in 2003, which is still well above the 2010 target of 10 per cent. In eight Member States (the Czech Republic, Germany, Estonia, Spain, France, Cyprus, Hungary, Slovakia) rates have increased since 2002. Progress towards the EU target depends critically on progress in Spain, Italy and Portugal, where levels are significantly above the EU average. Significant falls occurred in the Member States with the highest rates, notably Portugal and Malta (with levels still above 40 per cent).

Creating room for manoeuvre to redirect expenditure requires further reforms to face the budgetary impact of ageing

One of the ways to strengthen the public sector contribution to growth is by redirecting spending towards growth-enhancing, cost-effective investment in physical and human capital. However, changes in the composition of public finances are difficult to achieve in the short term. Table 2.4 presents the data currently available for the functional classification of public expenditure for EU-15 excluding Spain. It shows that Social Protection is the largest expenditure category, followed by General Public Services and Health. Changes for the period 2000-2002 are relatively small. For the period 1995-2002 as a whole, the figures show an increasing share of expenditure on Social Protection and Healthcare, while expenditure on Economic Affairs and General Public Services decreased its share in total expenditure. Agreed long-term projections on the impact of ageing, which are based on a no-policy change scenario, imply further relative increases of public expenditure mainly on Pensions and Health.. Therefore, in order to create room for redirecting public expenditure towards high priority areas, expenditure control and further reforms to face the budgetary impact of ageing are essential.[15]

Table 2.4: Composition of public expenditure (percentage of overall public expenditure), EU-15 excluding ES

	1995	2000	2002
Economic Affairs[1]	13.0	8.2	8.4
Education	9.8	10.8	10.8
Health	11.6	13.5	13.9
General public services[2]	15.5	13.9	14.3
Social Protection[3]	38.0	41.2	40.7
Others[4]	12.0	12.4	11.9

[1]Includes agriculture, industry, energy and transport. [2] Includes interest payments. [3] Includes pensions. [4]Includes defence, public order and safety.
Source: Commission services.

An integrated approach towards the contribution of public finances to growth requires that also tax structures should be directed towards strengthening the growth potential by promoting employment creation and investment.

Empirical analyses suggest that the long-term trend in tax revenues and current spending (especially welfare spending) are to some extent both driven by the same demographic factors, namely dependency ratios. In other words, taxes have been pulled up to finance increasing levels of spending and in particular, labour taxes

15 Monitoring the functional composition of public expenditures is hampered by the lack of detailed (and actual) data also covering categories such as R&D and pensions. In 2004 a project has started in cooperation with Eurostat to improve data collection. This will allow further analysis of trends in public expenditure.

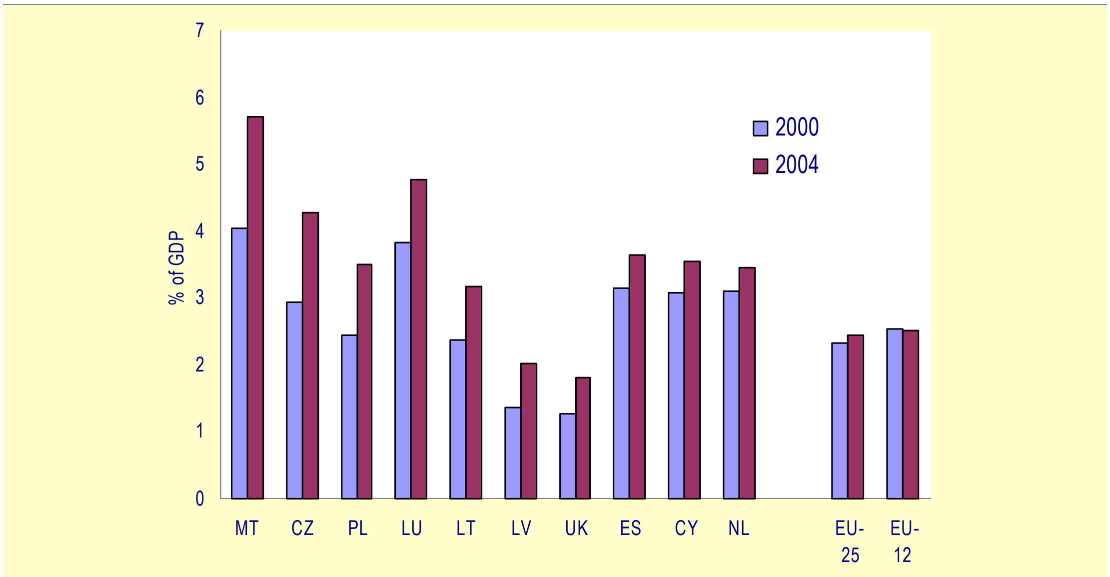
appear to have been rising steadily in industrial countries in order to finance welfare spending, especially pensions, health care and other social benefits. The tendency has been, however, reversed in the EU-15 Member States since 1996. In recent years, also the overall tax revenues as a percentage of GDP have declined slightly (see Table 2.5).

Table 2.5: Composition of total revenues as a percentage of GDP

	EU-25		USA		Japan	
	2000	**2004**	**2000**	**2004**	**2000**	**2004**
Direct taxes	14.0	12.7	15.4	11.4	8.6	7.6
Indirect taxes	13.7	13.6	7.3	7.2	8.4	8.1
Social contributions	14.3	14.2	7.2	7.0	9.8	10.2
Other	4.5	4.7	4.4	4.2	5.3	5.3
Total revenues	**46.5**	**45.1**	**34.2**	**29.8**	**32.2**	**31.1**

Source: Commission services.

Graph 2.15: Increases in public investment 2000-2004 (ranked by percentage point of GDP increase in investment)



Source: Commission services.

Long-term decline in public investment appears to have ended

Analysis of public investment should focus on the evolution of expenditure on growth-enhancing extensions of the public capital stock (net investment). However, data is presently only available for gross public investment expenditure, which is a crude measure of investment in physical capital while ignoring the importance of human capital. For the Union as a whole gross public investment (as a percentage of GDP) - having been on a downward path since the 1970s - has been largely stable between 2000 and 2004 at around 2½ per cent of GDP. Over the period of 2000-2004, public investment increased however significantly (more than 0.2 per cent of GDP) in 10 Member States (see Graph 2.15). Related to the process of 'catching up', increases of over 1 per cent of GDP were recorded in the Czech Republic, Malta and Poland, while a large increase is also visible in the United Kingdom, albeit from a relatively low base. In contrast, public investment as a percentage of GDP decreased in some Member States, most importantly so in Portugal (-1.4 per cent of GDP) and Germany (-0.4 per cent of GDP).

Box 4: Progress in implementing the European Growth Initiative

The European Growth Initiative, endorsed by the European Council in December 2003, stressed the role of public investment in key transport infrastructure to strengthen the interconnectivity of networks and thus the dynamics of the internal market. It includes *inter alia* accelerated public investment in a Quick-start list of 30 more or less mature transport projects of European relevance, which are part of the TEN transport priorities approved by the Union in April 2004. The information available shows that national public investment plans have been unevenly affected, though it is still too early to have a complete view of the impact of the initiative. While there is little evidence of an overall acceleration of investment, the implementation of transport projects in the Quick-start list in 2004 has proceeded more or less in line with plans. In most cases it consisted more in upgrading existing national infrastructure (mainly railway lines) than starting construction work for new infrastructures; only one new TEN transport infrastructure project actually started in 2004 (the Perpignan-Figueras railway line) as well as a new TEN energy project concerning the reinforcement of electric interconnections between France and Belgium (Avelgem-Avelin). In some cases, notably for large-size cross-border projects such as the Brenner tunnel and the Lyon-Torino rail link, which were put on top of the agenda by the Quick Start list, implementation has proceeded less quickly than initially planned due to technical delays, ambitious timeframes or difficulties in mobilising the necessary funding.

Increasing efficiency and controlling expenditure: still room for improvement

In order to enhance public sector efficiency, several Member States have introduced mechanisms for controlling public expenditure and reforms to the budget process that aim at better linking public expenditure to policy outcomes.

Expenditure rules can help Member States to respect the budgetary requirements of the EU fiscal framework, by better controlling expenditure categories that are subject to overruns, while at the same time reallocating expenditure towards high priority items. Effective control of aggregate categories of expenditure is a precondition for reforms of performance budgeting that shift focus from money spend to policy outcomes. Such reforms may improve the efficiency and effectiveness of the use of scarce resources so that savings can be achieved, while at the same maintaining of improving performance in achieving policy objectives. In this respect, the available empirical data indeed confirm that countries with more effective medium-term expenditure frameworks are also more advanced in introducing institutional reforms related to performance budgeting.[16] Recommendations to ensure or improve expenditure control were addressed in the 2003-05 BEPGs to Denmark, Greece and Finland, while Ireland and the United Kingdom were requested to ensure or enhance public sector efficiency.

Ireland extended the system of multi-annual spending envelopes from public transport to all areas of capital sending and adopted measures improving the efficiency and control of expenditures notably in health and infrastructure spending.

[16] See European Commission 2004, Public Finances in EMU 2004, Part IV The quality of public finances.

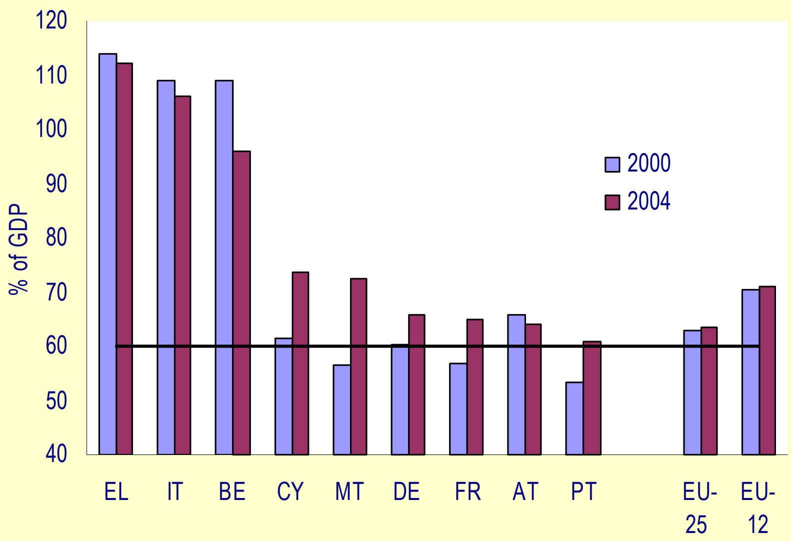
2.3 Strengthening sustainability

2.3.1 Economic sustainability: three-pronged strategy only partly implemented

Government debt ratio has not started to decline

After a small decline in the beginning of the decade, government debt (as a percentage of GDP) has increased again since 2002 and remains, on average, above 60 per cent of GDP. According to the Commission's 2004 Autumn Economic Forecast nine Member States are expected to have debt ratios exceeding the 60 per cent reference value in 2004 (see graph 2.16). The debt level in Greece, Italy and Belgium stands out in the EU-25 although Belgium has achieved a strong decline in the period 2000-2004 by almost 15-percentage points. In the same period debt also declined significantly in Spain and Ireland, while strong increases occurred in the Czech Republic, Germany, France, Portugal, Malta and Poland.

Graph 2.16: Government debt ratio for Member States exceeding the 60 per cent reference value



Source: Commission services.

This development should be seen in the context of the pressures on public finances stemming from ageing populations. According to the recent Eurostat 2004 population projections already in the period 2003-2025 the working age population is estimated to decline by 10 million persons or 3 per cent, although the total population is expected to increase by 17 million persons or almost 4 per cent. After 2025 the total population would start to fall from 468 million in 2025 to 447 million by 2050 while the working age population would decrease from 295 million to 252 million in 2050. At the same time, the population aged 65 and above would double in size from 76 million in 2003 to 135 million in 2050.

As a result the old-age dependency ratio (persons aged 65 or above to persons of working age 15-64) is projected to double from 25 per cent in 2003 to over 50 per cent in 2050. This development is expected to result in a substantial burden on public spending on age-related items, in particular on pensions, health care and long-term care. To address the economic and budgetary consequences of ageing, the Stockholm European Council decided a three-pronged strategy should be followed, focusing on increasing employment rates, reduction of public debt, and on reforming pension and health care systems.

So far the sustainability of public finances in view of the ageing population is far from secured in [about half] of the Member States.

Against this background, the 2003-05 BEPGs recommended Member States to: 15. ensure a further decline in government debt ratios; 16. design, introduce and effectively implement reforms of pension systems.

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

In 2004, the debt ratio declined or was kept unchanged in almost half of the Member States. On the basis of unchanged policies the Commission's 2004 Autumn Economic Forecast projects that over the period 2004-2006 not one of the nine Member States exceeding the 60 percent reference value in 2004 will achieve this reference value. Further significant declines are foreseen in Belgium and Spain, while in most Member States the debt ratio is either declining slightly or even showing a moderate increase (see part II for further detail). As a result, the debt ratios in some countries, such as Hungary and the Netherlands, are increasing towards the 60 per cent of GDP reference value.

In the EU as a whole, the current trends show an unsatisfactory rate of reduction of debt ratios. No progress has been made in bringing debt ratios sufficiently down before the full impact of ageing takes place. While the development of the debt ratios is linked to weak economic growth in recent years it is also a reflection of the lack of progress made in reducing budget deficits (as was already noted in section 2.1.2).

Pace of pension reform has varied substantially across the Member States concerned

Although major pension reforms have already been adopted in some Member States and further reforms are heavily debated in a number of countries, additional measures are required in many Member States. It is essential to move away from offering generous early retirement pathways, especially so in economic downturns or to cope with economic restructuring, in order to tackle reforms of the standard retirement age, replacement rates of pension entitlements, as well as adjusting pension benefits in case of early retirement in a way that ensures a better linking of benefits to contributions over the whole life-cycle. In total eleven Member States received country specific recommendations concerning the reform of their pension systems (Belgium, Czech Republic, Germany, Greece, Spain, France, Italy, Austria, Poland, Portugal and Slovakia).[17]

Compared to the assessment in the first Implementation Report when significant progress was noted, the record of the efforts to implement reforms of pension systems in 2004 is mixed. In several countries (e.g. France and Austria), where important pension reform measures were implemented in 2003, supplementary measures were introduced in 2004. In some countries, reforms were aimed broadly at monitoring and adjusting the implementation of the reforms. At the same time,

[17] Box 4 in annex 1 provides an overview of the measures adopted and proposed in 2004 as regards these country-specific guidelines.

however, further pension reform measures in some countries introduce long transition periods; moreover, newly finalised measures still provide incentives to retire early.

While in some countries, pension reform measures are underway…

Italy made an important step in 2004 towards securing a more sustainable pension system. However, while the reform will tighten the eligibility criteria for pensions, the development of the privately-funded pension pillar would require stronger incentives. Germany continued to overhaul its pension system by improving the financial balance of its public pension scheme and increasing incentives for retirement saving. Nevertheless, incentives for later retirement were only partially strengthened and an increase in the statutory retirement age beyond 65 was postponed. In Austria, the ambitious reform law from 2003 was modified by the new draft in several aspects. This includes new provisions which contrary to the previous objectives of the reform i) do not result in harmonised pension system and ii) introduce the possibility for early retirement.

In France and Portugal, the implementation of the reform measures introduced in 2003 continued, and in the latter, this included fine-tuning of some measures or extending the coverage of others. In Slovakia, where major reform measures were adopted in 2003, a sizeable funded pension pillar was introduced at the beginning of 2005. In Poland, in addition to close monitoring of the pension system that underwent reform in 1999, additional incentives are being planned for encouraging later retirement. Similar measures were recently adopted in Spain.

In 2004, the retirement age has been raised to 62 in Slovakia; and a few Member States (Belgium, Germany and Finland) have raised or plan to raise the minimum age of retirement, albeit gradually. Portugal has introduced a penalty for civil servants who retire early, the Czech Republic plans to eliminate further early retirement pathways in 2006 (see also the follow up to guideline 16). The Netherlands decided to end fiscal facilities for early retirement in 2006 but partly due to the long transition period granted, there is a risk that early retirement might not be reduced appreciably in the mean time. However, Austria plans introducing a "corridor" for early retirement beginning at 62**.**

… in others, little progress has been made

Pension reform measures that are currently being implemented in Greece seem insufficient for appropriate containment of the budgetary burden related to the budgetary costs of population ageing and should be complemented by additional efforts to reform the pension system. In the Czech Republic, the pension reform plans are only in the initial stage. On the basis of the proposals tabled by an experts' group, the government plans to make a decision on pension reform by 2006.

2.3.2 *Social sustainability*

There is a substantial need for both higher (potential) growth and social cohesion in an enlarged EU.

Table 2.6: Selected measures of risk of poverty rates in some new MS and the EU15, 2001

	(1) after social transfer	(2) before social transfer [2]	(3) Employed	(4) Unemployed
EU-15[1]	15	24	7	38
Czech Republic	8	18	3	30
Estonia	18	25	10	47
Lithuania	17	24	14	41
Hungary	11	17	5	33
Poland	15	31	11	37

Note: [1] weighted population average, [2] pensions excluded from social transfers.
Source: Commission services.

In particular, the necessary restructuring process may have a significant impact on the most vulnerable parts of the population in most of the new Member States.

Poverty and social exclusion across the Union are significant, with more than 15 per cent of the EU-15 population living below the poverty threshold in 2001. The risk of poverty rate in many of the NMS is broadly in line with that of the EU as a whole, see Table 2.6.[18] However, the risk of poverty rate masks differences in living conditions across countries.

Table 2.7: Unemployment and population in jobless households

	Total unemployment[1]		Long-term unemployment [1]		Population in Jobless households[2]	
	2000	**2003**	**2000**	**2003**	**2000**	**2003**
EU-25	8.7	9.1	4.0	4.0	-	10.2
EU-15	7.8	8.1	3.5	3.3	9.9	9.8
Cyprus	5.2	4.4	1.3	1.1	5.6	5.2
Czech Republic	8.6	7.8	4.2	3.8	7.8	7.7
Estonia	12.5	10.2	5.7	4.6	9.6	10.9
Hungary	6.3	5.8	3.0	2.4	13.5	11.6
Lithuania	16.4	12.7	7.6	6.1	9.2	7.4
Latvia	13.7	10.5	7.9	4.3	15.0	8.7
Malta	6.8	8.2	4.6	3.5	7.4	7.9
Poland	16.4	19.2	7.6	10.7	-	14.8
Slovenia	6.6	6.5	4.1	3.4	9.0	8.7
Slovakia	18.7	17.5	10.1	11.1	10.9	10.1

[1] Eurostat- Labour Force Survey and DG ECFIN, [2] People aged 18-59 living in jobless households.
Source: Commission services (incl. Eurostat, structural indicators).

18 The risk of poverty rate measures the share of the population (in %) living in households with a disposable income below 60% of the national median. Thus, the absolute value of the poverty line differs between countries.

There is also a wide variation in the risk of poverty rate across countries, ranging from 10 per cent or less in the Czech Republic, Sweden, Denmark, Hungary and Slovenia, and 20 per cent or more in Ireland, the Slovak Republic, Greece and Portugal.

A strong downward pressure on income differences is exerted by social transfers in all Member States, which reduce the poverty rate by 7-10 percentage points on average and even more in Poland. As evidenced in Table 2.6, employment plays a major role in lifting people out of poverty and social exclusion. Overall, unemployment has tended to rise since 2000 but with diverse evolutions across Member States. Unemployment rose sharply in e.g. Poland (reaching 19.2 per cent in 2003), whereas it tended to decrease in several of the other new Member States and especially in the Baltics. These evolutions are mirrored in the long-term unemployment rates, which nevertheless remain relatively high in most new Member States and in the population in jobless households, although the latter is lower than the EU 15 average in six of the new Member States (Table 2.7). Since shifting from unemployment to employment considerably lowers the likelihood of being exposed to the risk of poverty, measures that can facilitate better access to employment, in particular in the fields of education and housing, should be strengthened.

Regional income inequalities have also widened in the enlarged Union. For instance, the ten richest regions have a GDP per capita more than five times larger than that of the ten poorest regions (compared to an average income of 3.2 times higher in the ten richest regions within EU-15)[19]. Over the period 1995-2001, the new members have all experienced a substantial rise in regional inequalities as measured by GDP per capita, largely due to catching-up and the economic restructuring process through a (re)allocation of physical and human capital across regions, while the situation has remained broadly unchanged in EU-15. However, it has not been translated into higher disparities in terms of disposable income, as tax/benefit systems (excluding pensions) tend to play a major role in reducing income disparities. Regional inequalities in household income have been reduced by approximately 27.6 per cent for the EU-25 (see Table 2.8). While this redistribution effect tends to be larger for the EU-15 countries (-28.2 per cent), it is still sizeable for the new Member States (-24.9 per cent on average), and in particular for Slovakia (-35.8 per cent).

Table 2.8: Regional inequalities in household income: Gini index using primary and disposable income, average 1995-2001

	(1) Gini index	(2) Gini index	% change
	primary income	*disposable income*	(2) – (1)
EU-25 [1]	0.098	0.071	-27.6
EU-15	0.097	0.069	-28.2
Czech republic	0.088	0.067	-23.1
Poland	0.102	0.079	-23.3
Slovakia	0.142	0.091	-35.8
Hungary	0.139	0.105	-24.9

Note: Country groups are weighted (population) averages Gini index computed using average household income in NUTS2 regions by country. EU25 excludes Luxembourg, Ireland, Denmark, Estonia, Cyprus, Latvia, Lithuania, Malta, Portugal, Slovenia . Data for the Czech Republic and Hungary concern the years 2000-2001, for Poland, 1999-2001 and for Slovakia.
Source:Commission services incl. Eurostat.

19 Figure for 2001, regions NUTS2.

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

17. take steps to modernise social protection systems and to fight poverty and exclusion with a view to supporting the broad Lisbon objectives;
18. improve the functioning of markets so that they are conducive to private investment in regions lagging behind, particularly by allowing wages to reflect productivity differences;
19. ensure that public support in regions lagging behind is focused on investment in human and knowledge capital, as well as adequate infrastructure, and that investment programmes are designed and administered efficiently.

Reforms of social protection systems still piecemeal in most cases

Measures addressing the tax benefit systems in order to improve participation continued to concentrate on taxes in 2004 (in e.g. Belgium, Denmark, Austria, Slovenia, Finland and Sweden), see also the follow-up to guideline 4. In some Member States, changes have recently also been introduced that will reduce non-wage labour costs (Estonia, Hungary, Latvia and Slovakia).

Reforms of the unemployment and welfare related benefit systems have been less comprehensive. Some Member States have or will tighten conditions for the eligibility or duration of benefits (Czech Republic, Germany, France, Lithuania, the Netherlands, Slovenia and Slovakia). In some cases, the provision of social assistance has been limited (the Netherlands) or reformed to improve work incentives (Slovakia).

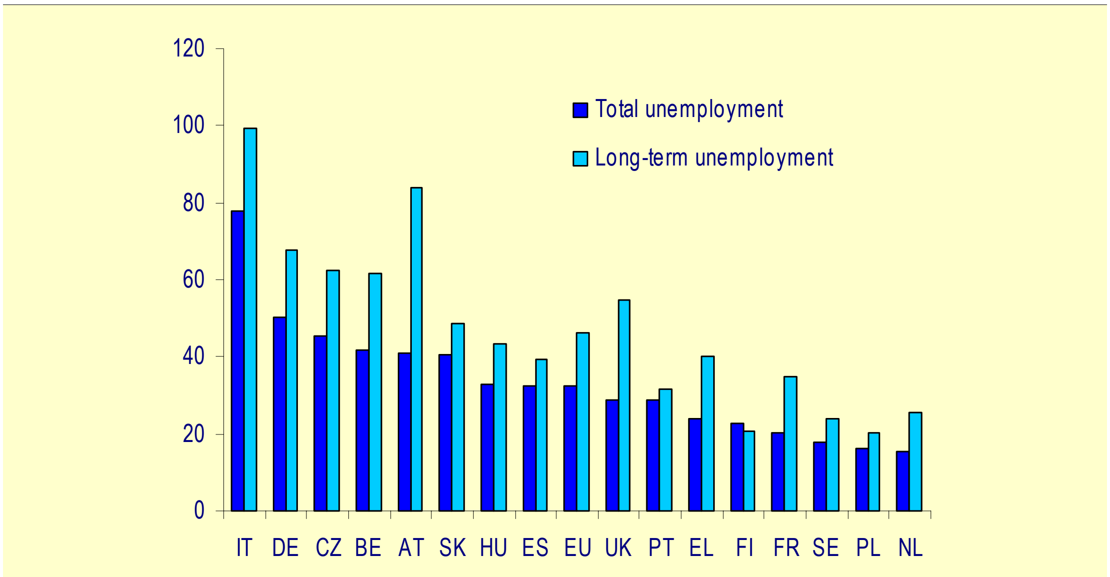
Efforts to facilitate access to the labour market of those at a disadvantage are on-going. Measures to foster the employment of persons with disabilities have been either reinforced or introduced in 2004 in many Member States (Czech Republic, Germany, Spain, Estonia, Hungary, Portugal and Slovenia). Pilot schemes are being tested in the United Kingdom. A reform of the disability scheme in 2006 has been decided in the Netherlands.

Other vulnerable groups such as the young job starters or the long-term unemployed are often targeted by changes in tax and social security systems (e.g. Hungary and Slovenia) or by specific packages (e.g. in Czech Republic , Estonia) or in the French social cohesion plan.

Little action noted to allow wage differences to better reflect productivity and local labour market conditions in order to tackle regional labour market differences

Less policy consideration has been given to **regional disparities** in labour markets although high regional unemployment and long term unemployment rates entail risks of social exclusion. Regional differences in both employment and unemployment rates have slightly decreased between 2000 and 2003, from 13.4 per cent to 13 per cent for the EU-25 and from 13.5 per cent to 12 per cent for the EU-15. Disparities in terms of employment and unemployment rates are still sizeable across EU regions, however. For instance, the two regions with the lowest unemployment rates, namely Bolzano (Italy) and Salzburg (Austria) had unemployment rates equal to 2 and 2.3 percent respectively in 2003, while regions such as Dolnoslaskie and Zachodniopomorski, both located in Poland, had unemployment rates equal to 26.0 per cent and 25.5 per cent respectively.

Graph 2.17: Regional unemployment dispersion in EU countries, 2003 (coefficient of variation across NUTS2 regions)



Source: Commission services.

Regional dispersion in long-term unemployment rates varies greatly across countries. Countries such as Greece and Poland, where the national rate of long-term unemployment is relatively high, have, in contrast, lower regional dispersion in long-term unemployment compared to the EU average. In other countries, long-term unemployment seems to be much more concentrated geographically such as in Belgium, the Czech Republic, Germany and Italy pointing toward region-specific problems within the domestic labour market.

No major initiative has been taken in the Member States most concerned to allow wages to better reflect differences in regional and local labour market conditions in 2003 or 2004. In Spain, the interconfederal agreement that allows for elements of flexibility based on sectoral and company conditions has been extended to 2004. The government has also announced its intention to strengthen collective bargaining so as to better reflect local as well as firm-specific conditions. In Italy, social partners have started talks in 2004 with a view to exploring possible changes to the wage-setting mechanism.

Measures taken at both EU and national level to enhance the effectiveness of investments

Steps have been taken by the new Member States to give their public investment mix a more Lisbon-oriented profile. On aggregate, spending on human resources will attract a growing share of total public spending in the period 2004-2006, while the share of basic infrastructure will decline[20]. However, due to the important needs of the new Member States the latter will still represent more than 50 per cent of public investments. The EU structural and cohesion funds will contribute some 24 bn € at current prices to the '2004-2006 economic and social development programmes' of

[20] According to data on national public structural support including the EU assistance in the lagging so-called objective 1-regions available from the ex-ante additionality assessments for the period 2004-2006. These data allow for a comparison with recent years (1999-2002).

the new Member States that was formally adopted in June 2004, following an agreement on their content concluded in December 2003.

In the EU-15 some Member States are taking steps to improve the design and management of public investment programmes. In Ireland a five year capital investment programme has been introduced from the 2004 budget and the government also continues to encourage public-private partnership. In the United Kingdom, a new strategy is being devised, following a major review in 2004, to increase public sector efficiency: an input-oriented approach should complement the existing focus on output and results. In Denmark, a reform of the structure and allocation of responsibilities in the public sector implies fewer and larger municipalities and the replacement of counties by five regions is being prepared.

In the context of the Structural Funds programmes for 2000-2006, two instruments were implemented that aimed at ensuring that resources were spent as effectively as possible. Firstly, mid-term evaluations were carried out and their recommendations considered in the usual mid-term reviews of the Structural Funds. Secondly, the performance reserve linked for the first time performance to financial allocations when national authorities, in close cooperation with the Commission, used a set of indicators targeting effectiveness, management and the take-up of funds as a basis for the allocation. Both instruments contribute to a more results-oriented management of the structural funds.

As a follow up to the third report on economic and social cohesion, legislative proposals for the post 2006 structural and cohesion funds have been presented in July 2004, which aim at further supporting the Lisbon strategy and at simplifying the Community assistance.

2.3.3 Environmental sustainability

Maintaining a high level of environmental quality may have wider benefits

Environmental policy has as its first goal the safeguarding of the natural environment which is a key determinant of the quality of life. Environmental policies can also be a source of competitive advantage for Europe, but this is not automatic. They are more likely to increase competitiveness if they get prices right and so provide opportunities for innovation and the creation of new markets and investment opportunities.

Market-based instruments such as emissions trading schemes, or taxes and charges that internalise external costs of pollution also help to do this. In this way, they can support structural reforms in other areas as well as yielding environmental benefits**.**

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

20. reduce sectoral subsidies, tax exemptions and other incentives that have a negative environmental impact and are harmful for sustainable development. Ensure, *inter alia* through the use of taxes and charges, that pricing of the extraction, the use and, if applicable, the discharge of natural resources, such as water, adequately reflects their scarcity and all resulting environmental damage;
21. reduce subsidies to non-renewable energy and promote market instruments, further broaden the coverage, and ensure appropriate differentiation of energy taxation;

22. adjust the system of transport taxes, charges and subsidies to better reflect environmental damage and social costs due to transport, and increase competition, e.g. through accelerated regulated market opening, in transport modes such as freight railways;
23. renew efforts to meet commitments under the Kyoto protocol and implement the EC greenhouse gas emissions trading scheme and set up systems to report on those policies and measures and their prospective effects on emissions. Take measures to reach the targets set by subsequent European Councils, notably on energy efficiency, renewable energy and bio-fuels.

Mixed progress has been recorded in using market-based instruments such as taxes and charges to give price signals regarding pollution and the use of natural resources ….

The Netherlands will launch, in mid-2005, a trading system to cut industrial emissions of nitrogen oxides (NO_x) by over 55 per cent by 2010. It will be a "dynamic baseline-and-credit system" which will fix a relative ceiling[21] for NO_x emissions per unit of energy. This ceiling will be progressively tightened to meet the targets of the NEC directive[22] by 2010. Companies that overachieve their relative ceiling can sell emission rights to those that have difficulties achieving it. The trading system ensures an overall compliance and provides a cost-effective incentive to reduce emissions. However, it remains to be seen how high the transaction costs of the Dutch system are.

In some cases, instruments to pursue other policy objectives induce environmental benefits. A first analysis of the charging scheme to reduce congestion in central London, which had been introduced in 2003, shows that NOx and particulate matter emissions from vehicles fell by 12 per cent in 2004 in that area. The United Kingdom has announced real increases in its landfill tax over the coming years, while Ireland, following the success of the "plastic bag" tax, is considering similar instruments to address other forms of litter. However, Ireland also abandoned its planned carbon tax, apparently because of fears about the impact on poorer households. Portugal has postponed the introduction of such a tax.

… but high oil prices have sent a strong signal to improve energy efficiency and to further develop the market for alternative fuels.

The transport sector remains highly dependent on oil – in the case of road transport, almost entirely so, notwithstanding Community targets to increase the use of bio-fuels. Pure or blended with petrol or diesel, they are a first step to reduce the dependence of the sector on hydrocarbons. Nevertheless, several Member States, including France, Austria, Sweden and the United Kingdom adopted tax reductions on biofuels in order to promote their use as road fuels. Although most of the price of petrol and diesel at the pump is made up of taxes, the rise in oil prices has nevertheless had a marked impact on road fuel prices, which should encourage more fuel-efficient vehicles. Some Member States have chosen to reinforce this impact. First analyses from the United Kingdom indicate that modifications in the taxation of company cars that were introduced in 2003, led to reductions of carbon dioxide (CO_2) emissions of about 200,000 tons. Furthermore, Belgium introduced fiscal

21 Referred to as Performance Standard Rate (PSR)
22 Directive 2001/81/EC; published in the Official Journal No. L 309 of 27 November 2001.

incentives to encourage the purchase of cars with low levels of CO_2 emissions per kilometre, while Austria and the Netherlands have decided to introduce tax incentives for diesel cars that achieve 80 per cent reduction of particulate matter compared to current standard. Other Member States are considering similar schemes. Road pricing measures for heavy lorries remain implemented in a poor and fragmented way due to delays in setting up a community framework for infrastructure charges that would encourage the integration of external costs.

More generally, the high oil prices experienced during 2004 will – if sustained – help encourage greater energy efficiency and boost investment in low-carbon energy sources, provided that Member States do not react by adjusting fuel taxes, so weakening the price signal. However, a number of Member States have reacted in precisely this way, in spite of the Commission's opposition. Hungary and Slovenia have reduced excise duties, while Latvia and the United Kingdom delayed previously foreseen duty increases. Other Member States have announced support for specific sectors (fishermen and farmers in France and Spain) and households in Belgium.

Market-based measures taken to encourage energy efficiency include increased income tax rebates in Belgium for investments in energy efficiency in the household sector, while Italy has introduced a system of tradable "white certificates" for energy efficiency improvements, analogous to the "green certificates" that some Member States have already introduced in favour of renewable energies.

Denmark has restructured its support for renewable energy sources, replacing obligations for the purchase of renewable energies with a system of subsidies based specific to different types of renewable energy. In its recent Communication[23], the Commission concluded that unless more active and effective policies are put in place, the indicative target on electricity from renewable energy sources will not be achieved. Four countries - Denmark, Germany, Spain and Finland –are on track for achieving the non-binding renewable electricity targets.

Market opening is gaining ground and making freight railways more competitive

Rail freight market opening began in March 2003 on the majority of the international lines. Regulated competition will increase quality and will raise confidence in railways among industrial users. All new Member States have notified implementation measures except for the Slovakia and Czech Republic (only partly). Infringement procedures for non-communication of implementation measures are running against Germany, Greece, Luxembourg and the United Kingdom. Infringement procedures for non-conformity of the implementation measures have been started against Belgium, Spain and the Netherlands. Effective competition on the rail freight market exists in Denmark, Germany, Italy, Netherlands, Sweden and the United Kingdom.

Preparations to tackle climate change intensified in 2004….

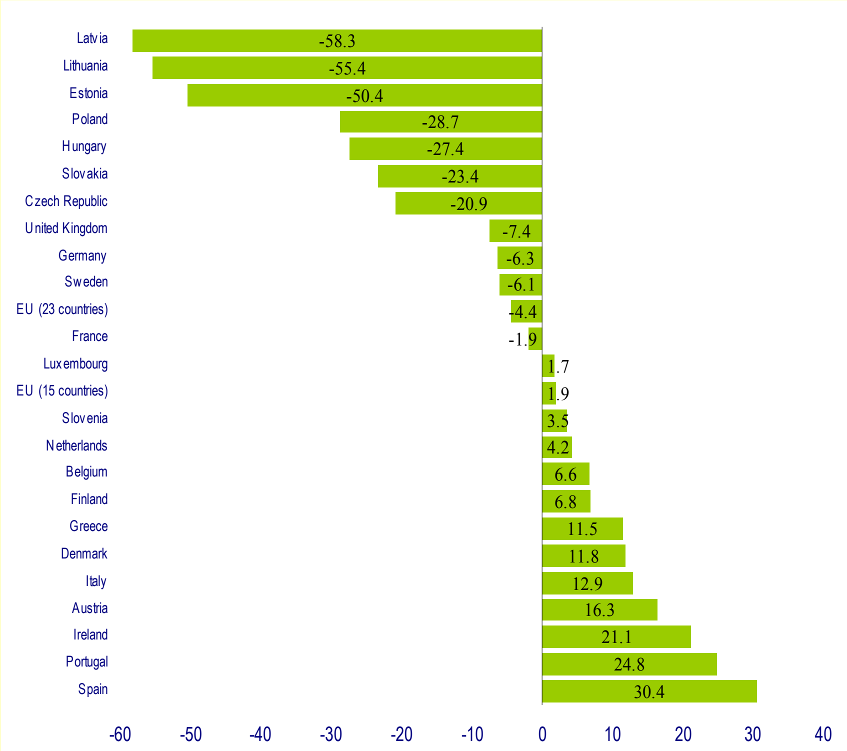
Russia's decision to ratify the Kyoto protocol to the UN framework convention on climate change – essential for the protocol to take effect following the United States' withdrawal from the protocol – has added urgency to the EU's efforts to put in place effective policies and measures to reduce greenhouse gas emissions, as it removes

[23] Communication from the Commission to the Council and to the European Parliament 'The share of renewable energy in the EU". COM(2004) 366 final.

any residual doubts about the existence of internationally-binding greenhouse gas emission constraints.

Considerable efforts have been made to ensure the Community greenhouse gas emissions trading scheme started on 1 January 2005. In particular, although few Member States met the legislative deadline of 31 March for submitting their draft national allocation plans under the Community greenhouse gas emissions trading scheme, nevertheless, by the end of 2004 all Member States had submitted plans, and the Commission had approved the allocation plans of twenty-one Member States. Combining the numbers from these plans sets the overall limit on the quantity of carbon dioxide which the companies covered by the Directive can emit. All these companies – covering some 40-45 per cent of Community greenhouse gas emissions – will regularly have to surrender emission allowances corresponding to their actual carbon dioxide emissions. Ahead of this date, an active forward market in emissions allowances had already emerged.

Graph 2.18: Distance to target indicators for the Kyoto protocol and burden sharing targets of the EU Member States[1]



Explanatory note: the distance to target indicator measures in percentage points how close current emissions are to a hypothetical linear path to the Kyoto target for 2008-2012, assuming only domestic measures are used and taking base year emissions as the emissions of the year 1990. A negative value indicates emissions are ahead of target; a positive value indicates that the country is not on track to meet its Kyoto commitment.

[1] Malta and Cyprus do not have targets under the Kyoto protocol.

Source: Commission services.

Several Member States also advanced their preparations to acquire additional tradable units under the Kyoto protocol thus substituting reductions via domestic policies in the first commitment period by funding greenhouse gas abatement projects in other countries, under the so-called “Clean Development” and “Joint Implementation” mechanisms established under the Kyoto protocol.

In this context, Council and the European Parliament adopted the directive to allow companies covered to acquire and use Kyoto units in the EU emission trading scheme[24]. Furthermore, Council reached political agreement on measures to reduce emissions of fluorinated greenhouse gases, for example by better servicing and by phasing out such gases in air conditioning systems of motor vehicles.

… although much remains to be done in most of the former EU-15 Member States

There is a strong contrast between the new Member States and most of the former EU-15 Member States as regards the scale of efforts that are needed to meet the Kyoto commitments.

In the new Member States[25], the economic restructuring that has been part of the transition to a market economy has typically resulted in steep falls in greenhouse gas emissions, so that their emissions are well below the levels allowed under the Kyoto Protocol (except for Slovenia). With a few exceptions (United Kingdom, Germany, Sweden and France), the former EU-15 Member States are off track, and need to accelerate their emissions reductions if they are to meet their Kyoto commitments. Several of the EU-15 Member States have not met their obligations to transpose the emissions trading directive into national law in order to implement it. The Commission has started legal action against those Member States. <u>However, it should be noted that difficulties with the compliance with legal reporting requirements in a number of Member States continues to hamper the evaluation of actual and projected progress.</u>

24 Directive 2004/101/EC, published in the Official Journal No. L 338 of 13 November 2004

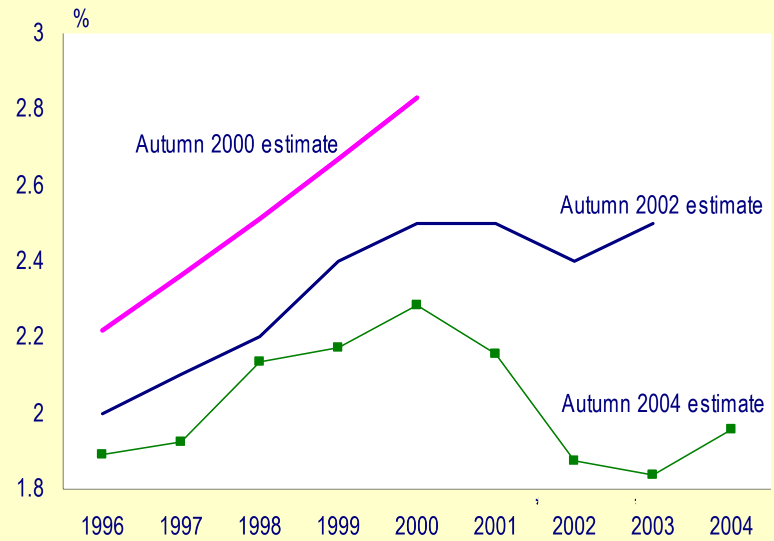
25 Except Cyprus and Malta, which do not have commitments under the Kyoto protocol.

3. EURO AREA SPECIFIC CHALLENGES

Economic growth recovered in 2004 but remains subdued

Growth in the euro area began to slowdown in 2000 amidst a deceleration in the global economy in the context of global uncertainties and falls in asset prices. With domestic demand insufficient to provide a buffer from the global downturn, GDP growth fell from 3.5 per cent in 2000 to an average of a mere 1 per cent over the period 2001-2003. The failure of growth in the euro area to pick up rapidly highlighted the fact that economic growth remained below its potential. Moreover, potential growth itself remained weak. In recent years, Commission estimates of potential growth in the euro area have been revised downwards significantly (see graph 3.1) and the current estimate for potential growth in 2004 is now around 2 per cent.

Graph 3.1: Estimate of the rate of potential growth, euro area



Source: Commission services.

These downward revisions are partly related to a smaller contribution of labour to growth, but mainly reflect the slowdown in actual labour productivity growth. This productivity slowdown can be decomposed into a slightly lower contribution of capital deepening (due to a cyclically-related lower investment ratio) and a lower contribution from independent technical progress or total factor productivity, which is the main cause of the revision.[26]

Against this background, the 2003-05 BEPGs identified four challenges facing the euro area:

- strengthen potential growth,
- cater for balanced macroeconomic policies,
- monitor inflation differences,
- strengthen economic policy coordination.

[26] The sensitivity of the calculation method of potential growth to actual developments implies that potential growth estimates could return to higher rates if labour productivity growth picks up.

and therefore recommended policy actors at national level to:

24. contribute to a policy-mix that is compatible with price stability and with economic growth close to potential in the medium term;
25. maintain budgetary positions close to balance or in surplus throughout the economic cycle in cyclically-adjusted terms and, if needed, take all the necessary measures to ensure an annual improvement of at least 0.5 per cent of GDP. Countries with excessive deficits need to correct them;
26. analyse the causes of inflation differences to identify instances when they are undesirable;
27. deepen the analysis of economic developments and policy requirements, focus more on implementation, and strengthen the external representation of the euro area;
28. improve the efficiency of the existing co-ordination procedures in the area of structural reforms; intensifying structural reforms.

The 2004 update of the BEPGs reconfirmed that economic policy required to be much more focused on sustained growth without hampering further budgetary consolidation.

Economic activity remained subdued in 2003, with annual GDP growth slowing to just 0.6 per cent and unemployment increasing by almost half a per cent to 8.8 per cent. Euro area growth finally strengthened in 2004, supported by buoyant global growth. GDP growth increased to around 2 per cent in 2004, building on the pick-up in activity that emerged in the second half of 2003. Nevertheless, in comparison to other industrial countries, the economic recovery in the euro area was sluggish and late starting. Amidst world trade growth estimated to have reached almost 10 per cent in 2004, the US registered a GDP growth of above 4 per cent while growth in Japan is estimated to have been around 3 per cent.

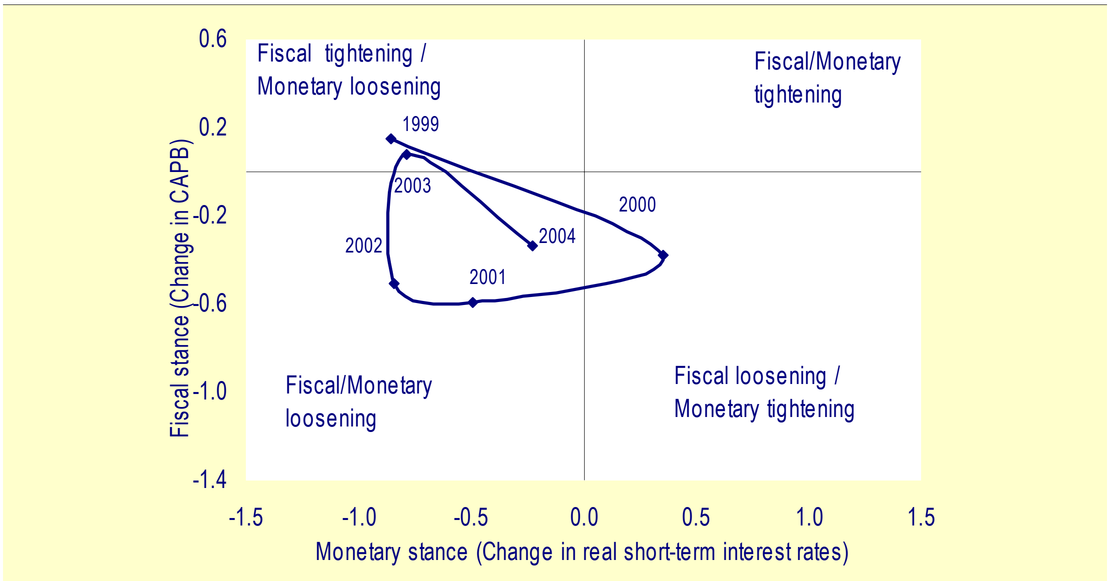
The pick-up in GDP growth in the euro area has so far not led to a significant increase in employment. Employment growth is estimated to have picked-up only slightly on the 0.2 per cent growth seen in 2003, to record 0.5 per cent in 2004. The increase in unemployment is likely to have come to a halt in 2004 at a level of 8.9 per cent.

Looking forwards, euro area growth is expected to continue at around 2 per cent in 2005, despite higher oil prices taking their toll. Growth will be supported by a strong acceleration in investment expenditure, and reinforced by a more gradual pick-up in private consumption. Employment growth is expected to increase to almost 1 per cent in 2005, while the unemployment rate remains unchanged.

Policy mix continues to be supportive to growth

Macroeconomic policy remained accommodative in 2004, with a broadly neutral fiscal stance accompanied by a monetary stance which continues to be supportive to the recovery (Graph 3.2). The ECB left nominal interest rates unchanged throughout 2004, with the minimum bid rate remaining at 2 per cent; real short-term and long-term interest rates remained at historical lows. Real short-term interest rates even turned negative in several months. This accommodative monetary stance is visible in the financial system in a rise in bank loans to the private sector. In 2004 the nominal effective exchange rate of the euro appreciated by 3.8 per cent on average compared to the average in 2003. This appreciation of the euro provided some downward pressure on external demand but also acted as a counterweight to the rising commodity prices. Both in 2003 and 2004 the fiscal policy stance, measured by the change in the cyclically-adjusted primary balance, was broadly neutral. This neutral of discretionary fiscal policy provides room for automatic fiscal stabilisation.

Graph 3.2: Policy-mix in the euro area

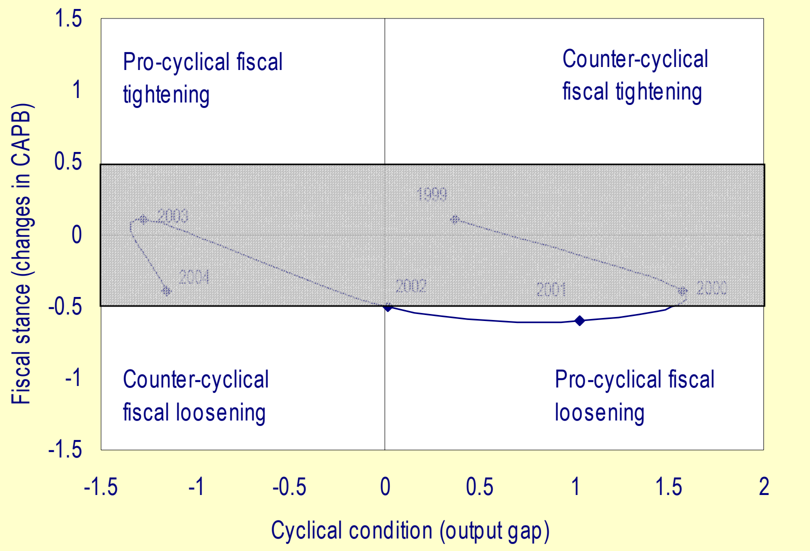


Source: Commission services.

Insufficient budgetary consolidation in the Member States with high deficits in 2004

The fiscal position deteriorated somewhat in the euro area in 2004 with general government net borrowing increasing to just below the 3 per cent of GDP ceiling, while the cyclically adjusted deficit rose to 2.5 per cent of GDP. However, differences are substantial across Member States. Four of the five countries with a close-to-balance budgetary position in 2003 (measured as a broadly balanced budget or in surplus in cyclically-adjusted terms) managed to maintain such a position in 2004, namely Belgium, Ireland, Luxembourg and Finland, whereas one-off measures taken by the new Spanish government caused their balance to turn into a deficit. According to the Commission's Autumn 2004 Economic Forecasts the deterioration noted in Spain in 2004 will be temporary. Of the seven Member States that had not yet achieved a position of "close-to-balance" in 2003, none undertook sufficient efforts to ensure an improvement in the cyclically-adjusted balance of at least 0.5 percentage points of GDP in 2004, although a certain improvement was noted in France and the Netherlands. The cyclically-adjusted budget deficit actually deteriorated for all the other Member States in question (i.e. Germany, Greece, Italy and Austria). Based on the changes in the cyclically adjusted balance not one single Member State managed to comply with the agreed minimum improvement in 2004. Four Member States show an adjustment of 0.5 per cent of GDP or more in 2005 (Germany, Greece, France and – nearly - the Netherlands). The broad picture would not change much even allowing for a correction in the change in the cyclically-adjusted balance to account for the impact arising from growth surprises (i.e. potential growth different than forecast).[27]

Graph 3.3: Euro area fiscal stance and cyclical conditions 1999-2004



The shaded area represents a broadly neutral stance.
Source: Commission services.

Of the three euro area Member States in an excessive deficit situation in 2003, Portugal managed to bring its deficit below 3 per cent of GDP in 2003 and its excessive deficit procedure was consequently abrogated on 11 May 2004. However, according to the autumn 2004 forecast the deficit in Portugal risks again exceeding the 3 per cent of GDP ceiling in 2005. The deficits recorded for Germany and France both remained well above 3 per cent of GDP in 2004. Continued subdued domestic demand in Germany and a large reduction in income tax rates, which was only partly financed by a broadening of the tax base, both contributed to a certain widening of the deficit. As indicated above, the general government deficit in France improved somewhat in 2004 also in view of the higher-than-expected growth. However, the deficit could have narrowed more significantly had the automatic stabilisers been allowed to play fully. The Commission's Autumn 2004 Economic Forecasts, based on unchanged policies, project an improved budgetary position in Germany and France to 3.4 respectively 3.0 per cent of GDP in 2005.

In 2004, Greece and the Netherlands were also found to be in an excessive deficit situation. In the case of Greece, the deficit for 2003 has been revised upwards repeatedly to around 4½ per cent of GDP highlighting the recent expansionary, pro-

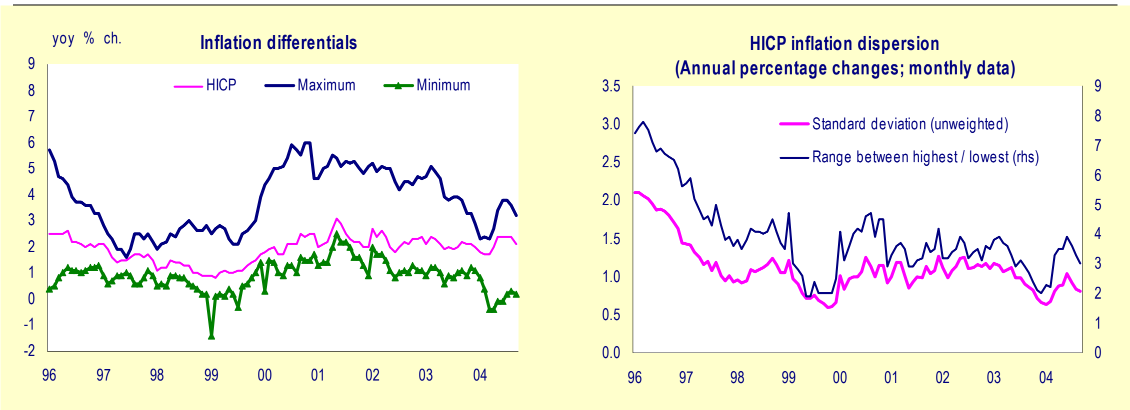
[27] The assessment of the fiscal effort of countries was discussed in the context of a revision of the SGP along the lines proposed by the September 2004 Commission Communication on "Strengthening economic governance and clarifying the implementation of the SGP". It was concluded that a correction of the CABB to account, *inter-alia*, for the impact of growth surprises could improve the assessment of the path of Member States towards the medium-term objective and that the assessment should also be complemented by a bottom-up approach aimed at evaluating the budgetary impact of the discretionary fiscal measures taken. The 2004 Public Finance Report provides a description of a methodology for correcting the change in the CABB for growth surprises. The analysis contained in the 2004 Public Finance Report shows that such a correction would in general have a quite limited impact on the CABB changes, and that a significant effect would arise only in case of actual growth substantially lower than potential.

cyclical (looking at the positive output gap) fiscal policies. In the Netherlands, and despite a substantial package of fiscal savings, the sharp economic downturn caused the deficit to exceed the 3 per cent of GDP ceiling in 2003. A clear improvement is expected in both cases, even if it appears unlikely (assuming no policy changes) to be sufficient to reduce the Greek deficit to below 3 per cent of GDP by 2005 if no further measures are undertaken. As regards Italy, which was also recommended "to take appropriate measures" in response to the possible existence of an excessive deficit in the 2004 update of the BEPGs, the Council decided not to issue an early warning as recommended by the Commission following the announcement of a savings package by the Italian authorities in July 2004. According to the Commission's forecast, however, a deficit of 3 per cent of GDP appears likely in both 2004 and, under the assumption of unchanged policies, in 2005.

Inflation differences are narrowing

Inflation differences in the euro area, as measured by the difference between the Member States with the highest and the lowest HICP inflation rates and by the unweighted standard deviation, both fell for the second consecutive year in 2004, although they remain above the levels seen in the early years of EMU. However, indirect tax cuts have kept inflation in Finland unusually low, and if Finland is excluded from the calculations, inflation differences are smaller than five years ago.

Graph 3.4: Inflation differences and dispersion, euro area



Source: Commission services.

From a historical perspective, the inflation dispersion in the euro area seems low, although given the relatively short experience with it, a degree of caution is required in interpreting results from such comparisons.

Since the start of Stage Three of EMU, some countries have registered persistent differentials relative to the euro area average. Temporary differences in inflation rates may arise from price shocks such as temporary rises in oil or food prices, given different consumption patterns in Member States. Price changes may also be policy induced, arising for example from changes in indirect taxation or differences in the pace of deregulation of utilities. But as Table 3.1 shows, even after the effect of changes in energy prices and unprocessed food have been stripped out as measured by core inflation, significant inflation differences remain between Member States. Core inflation does not exclude changes in indirect taxes, which in 2004 took place primarily in relation to alcohol and tobacco. The low inflation rate in Finland can be accounted for by cuts to indirect taxes on a number of consumer goods, including alcohol, whilst large increases in tobacco taxes in France, the Netherlands and to a lesser extent, Germany and Italy, placed upward pressure on overall inflation in those countries.

Table 3.1: Euro Area inflation: annual change to November 2004 (percentage weights in parenthesis)

	HICP	Industrial goods (ex. Energy)	Energy	Unprocessed food	Processed food (incl. alcohol + tobacco)	Services	Core inflation
BE	2.3	0.1 (33)	12.7 (9)	1.0 (8)	2.1 (12)	1.9 (38)	1.2 (82)
DE	2.0	0.8 (30)	7.0 (10)	-2.4 (5)	2.6 (11)	2.0 (44)	1.7 (85)
EL	3.2	2.5 (31)	12.7 (7)	-4.4 (9)	3.7 (14)	3.6 (39)	3.2 (84)
ES	3.5	1.3 (30)	9.9 (9)	2.7 (13)	4.2 (13)	3.8 (36)	2.9 (78)
FR	2.2	0.4 (30)	10.9 (8)	-0.9 (9)	1.7 (12)	2.7 (42)	1.7 (84)
IR	2.8	-1.1 (23)	15.3 (7)	-1.0 (7)	1.7 (17)	3.7 (46)	2.0 (86)
IT	2.0	1.6 (34)	6.0 (6)	-2.1 (8)	2.6 (11)	2.6 (40)	2.2 (86)
LU	4.0	0.6 (35)	21.1 (9)	-0.2 (5)	5.4 (20)	2.5 (32)	2.4 (86)
NL	1.5	-0.4 (33)	6.5 (8)	-5.1 (5)	0.4 (11)	3.1 (42)	1.4 (86)
AT	2.4	-0.1 (30)	12.9 (7)	-1.8 (6)	1.0 (11)	3.1 (46)	1.7 (87)
PT	2.6	0.9 (32)	10.8 (8)	-1.3 (11)	1.6 (11)	3.7 (38)	2.3 (81)
FI	0.2	0.0 (30)	8.5 (7)	-1.4 (7)	-5.1 (16)	1.4 (40)	-0.3 (86)

Source: Commission services.

Even differences in core inflation can to some extent be considered a normal adjustment mechanism in a monetary union. Given that, by definition, the nominal exchange rate instrument is no longer available for national purposes, required national adjustments in a monetary union fall on relative price and wage movements. In particular, according to the Balassa-Samuelson (BS) model, inflation may be higher in catch-up economies. This arises from the fact that catch-up economies may enjoy relatively high productivity growth in the tradable (predominantly manufacturing) sector, forcing up wages (but not the price of tradable goods). Higher inflation comes through price rises in the non-tradable sector, as labour mobility ensures that wages rise at the same rate as in the tradable sector, despite lower productivity growth.

Table 3.2: Actual inflation differentials and implied inflation differentials due to Balassa-Samuelson (catch-up) effects

	BE	DE	EL	ES	FR	IE	IT	NL	AT	PT	FI
Average estimated BS inflation differential[1]	0.6	-0.6	1.6	0.5	0.1	1.3	0.5	0.1	0.2	0.7	0.5
Average HICP differential 1999-2002	-0.0	-0.6	1.1	**1.0**	-0.4	**2.1**	0.3	**1.3**	-0.3	**1.2**	0.2
HICP differential 2003	-0.5	-1.0	1.3	**1.0**	0.0	**1.9**	**0.7**	0.1	-0.7	**1.1**	-0.7
HICP differential 2004	0.1	**-0.2**	1.0	**1.3**	0.0	0.6	-0.2	-0.7	0.2	0.4	-2.0

1: Average of six studies, taken from ECB, "Inflation differentials in the euro area", September 2003. No data for Luxembourg available.

Source: Commission services, ECB

Table 3.2 shows that in the early years of EMU, variations from the euro area average in Spain, Ireland, the Netherlands, and Portugal all significantly exceeded what we might have expected to observe, taking into account an average of estimated BS effects (in view of the fact that some of the Balassa Samuelson effects use data from the 1970s, it could be expected that the effect is smaller now, given that real convergence has taken place between euro-area Members).[28]. But in 2004, the difference in inflation fell in the majority of countries and in particular, fell below what would have been expected as result of BS effects in both Ireland and Portugal. Whilst inflation differentials in Germany are now slightly above what would be expected due to BS effects, the difference is only marginal, suggesting that the picture regarding inflation differentials has improved somewhat in recent years. Only in Spain, where service sector inflation remains particularly strong, have inflation differentials exceeded the expected amount in all three periods.

The persistence of inflation differentials may possibly indicate that structural rigidities are continuing to impede a smooth adjustment. While some structural differences across countries such as energy's share of consumption and size and export-orientation of the industrial structure must be seen as a given, there may be institutional barriers that reduce the speed of adjustment of prices and wages over the business cycle and to economic shocks. Inflation appears particularly persistent in the service sector, with the lower degree of competition in the service economy, the relative importance of labour costs and the relatively low exposure of the sector to external competition likely to be contributors to price stickiness. To the extent that agents still form inflation expectations on the basis of domestic rather than euro-area inflation trends, persistent differences in real interest rates, which seem to have aggravated remaining growth and therewith also inflation differences, are likely to persist. While structural reforms may ameliorate country specific inflation differentials, it should be recognised that in the short-term, differences in the speed and magnitude of implementation of structural reforms may temporarily accentuate inflation dispersion among Member States.

First step made in strengthening the voice of the euro area on the world stage

Progress is being made with regard to the internal coordination of common positions in international issues of particular relevance for EMU. For example, during the last episode of euro appreciation, the Eurogroup expressed to the outside world a coordinated view on exchange rate issues, which has supported the credibility of EMU's policy framework. The EU representatives in the IMF have also stepped up their efforts to coordinate their positions ahead of the Executive Board meetings by creating a troika including the representatives of the previous and next EU presidencies. By acting as a systematic and recognizable interlocutor with the IMF management and the staff, this troika is expected to enhance the continuity and visibility of EU common positions.

The need to ensure a proper and appropriate external representation of the euro area in the relevant international institutions and fora remains, however, a crucial challenge. The launch of the euro has not yet strengthened the representation of the euro area in international fora, which is still fragmented and incomplete and not commensurate to its economic weight. Ad-hoc arrangements continue to prevail with regard to different institutions, making it difficult for the euro area to speak with one voice at the international level. A noteworthy development is that in September 2004, the Eurogroup agreed on a new set of working methods, which included the creation of a stable presidency for a two year term that can be renewed one time only. It was agreed that, as of 2005, Jean-Claude Juncker*,* Prime Minister and Finance minister of

[28] In addition, the removal of one particular study from the average reduces the expected BS effects in Greece and Finland by 0.6 and 0.2 percentage points respectively.

Luxembourg would serve as the inaugural president. The switch to a stable presidency will improve the functioning of the Eurogroup and bring greater coherence and continuity to its dealings with international organisations like the IMF and G7 Finance Ministers' Meetings. Overall, this reform can be viewed as an important first step in ensuring that the interests of the euro area are properly represented on the world stage.

Analysis of economic developments and discussions on the euro-area have deepened

The dialogue among euro area policy actors has gradually advanced over the years going beyond actual economic developments to discuss structural issues and economic mechanisms in the euro area to a greater extent. In 2004, the Eurogroup ministers had e.g. discussions on the assessment of structural weaknesses of the euro area in light of the growth performance and also discussions on budget-neutral measures to strengthen growth, including by reducing the administrative burden weighing on the business sector. Ministers also discussed, in view of EU enlargement, a framework for analysing readiness of Member States to enter ERM II. Moreover, the Eurogroup discussed a coordinated policy-response to rising oil prices in marked contrast to the divergent policies adopted in earlier years clearly showing that economic policy coordination is evolving.[29]

Report of the Kok-group stresses importance of national ownership, benchmarking and communication

In terms of the governance of the Lisbon strategy, the High Level Group on the Mid-Term Review of the Lisbon Strategy (in short Kok-group) made a number of recommendations to improve the coordination of structural reforms (see also box on page 16). These recommendations, while made for the EU 25, are equally valid for the euro area. The report underlined the need to ensure the commitment and ownership at the level of individual Member States. This can be done through national strategies with clear road maps and through enhanced involvement of national parliaments, the European Parliament and social partners in the process. In order to ensure more coherence and consistency of the reform efforts, the Broad Economic Policy Guidelines and the Employment Guidelines should provide the basic directions for the national strategies.

The report also recommended that the central elements of the open method of coordination (peer pressure and benchmarking) be strengthened by presenting to the Heads of States or Government and the wider public annual updates on countries' performances, praising good performance and castigating poor performance. Finally, the report stressed the importance of a clear communication to a wider public of the potential benefits of the reform effort. The Commission and Member States will work together to ensure that the report's recommendations are taken up by the 2005 Spring European Council. [The Commission has put forward its proposals in the 2005 Spring Report.]

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[29] An example of the deeper analysis of economic developments and policy requirements can be found in an assessment made by the Commission services on the first five years of EMU: "EMU after five years", 2004.

4. SUMMARY OF THE DEGREE OF IMPLEMENTATION BY MEMBER STATES

Part II of the report contains a detailed analysis of how economic policies in the Member States have responded to the challenges and country-specific recommendations contained in the 2003-05 BEPGs. The main focus of this analysis is the policy actions taken in the course of the year 2004. For the new Member States, this allows a preliminary assessment of the degree of implementation of the recommendations, which were adopted by the Council only half a year ago. For the EU-15 Member States, the analysis in Part II complements the previous Implementation report to allow for a more in-depth assessment of the degree of implementation of the recommendations, which were adopted one and a half years ago.

This chapter summarises the degree of implementation for each country, focussing on the degree to which each country is responding to the policy challenges identified for it. Even if the wording of these assessments is standardised, the difficulties surrounding a cross-country comparison of the state of implementation should be borne in mind. First and foremost, EU-15 Member States have had more time at their disposal to give an adequate follow-up to the recommendations than the new Member States. Second, the challenges identified for the different Member States differ not only in number but also in scope, i.e. some challenges are clearly more demanding than others.

Summing up and on the basis of the assessments in Part II, a relatively good follow-up of the country-specific recommendations has been given by Belgium, Denmark, Ireland, the Netherlands, Finland and the United Kingdom, while progress can be considered limited in several EU-15 Member States. Concerning the recommendations to the new Member States, addressed just half a year ago, the assessment of their implementation indicates that, albeit with different speeds, it goes in the right direction, notably in Cyprus and Slovakia.

4.1 Belgium

After one and a half years of implementation, Belgium has in general made good progress in addressing the three policy challenges that were identified in the country-specific part of the BEPGs. In particular, progress has been made on the challenge of public finance sustainability, as the reduction in the debt ratio has continued, although primary surpluses are diminishing and the decline in interest payments is slowing down. Regarding the recommendation to limit the yearly real increase of expenditure of Entity I (the federal government and social security) to 1.5 per cent, progress was limited in 2004: measures to control public expenditure were relatively successful, even if a substantial overrun in health care spending occurred. The government complied with the specific recommendation of allocating the proceeds from the higher than expected economic growth to improve the budgetary position. Some progress has been also made in preparing for the budgetary implications of population ageing, by reducing debt or financing the ageing fund, but the low effective retirement age remains largely unaddressed.

Some progress has been made in addressing the challenge of increasing participation and employment rates, especially of older workers. Some limited measures have been taken to stimulate employment in the age category over 50, but no new measures have been taken to limit the access to the system of early retirement and extend further the effective working life. Some progress has been made with the elimination of major distortions to work incentives, mainly through reductions in social security contributions targeted at the low-paid.

Finally, some progress has been made in addressing the challenge and recommendations on productivity and business dynamism. Good efforts have been made to reduce the administrative burden at all administrative levels and the reform of the public administration has been pursued, although more modestly. Improvements were made in liberalising network industries in 2004 although not further than the minimum requested by EU directives. However, no specific action has been taken to enhance effective competition in other local services.

4.2 Czech Republic

After half a year of implementation, the Czech Republic is making some progress in addressing the four policy challenges that were identified in the country-specific part of the BEPGs. In particular, progress is being made in addressing the challenge regarding public finances. As a step towards correcting excessive deficit by 2008 at the latest, the government implemented reforms on both the expenditure and the revenue side, including the introduction of medium-term expenditure ceilings for central government. However, action to address the long-term sustainability of public finances has been much more limited, in particular in the fields of pension and health-care policy.

Some progress is being made in addressing the challenge on the labour market. Measures have been introduced to reduce disincentives to work and to enhance occupational mobility, but little action has been taken to address the problems of regional mobility and skill mismatches.

Limited progress is being made in addressing the challenge of improving the conditions for an accelerated productivity growth. Despite some measures to reform the elementary and secondary schooling which should bring about a reform of the curriculum the overall reform of the education system and, in particular, tertiary education is still outstanding. On the other hand several measures to support R&D and innovation through, for example, investment incentives have been adopted and others are in the pipeline.

Finally, limited progress is being made in addressing the challenge on entrepreneurship and SMEs. Several important proposals to improve the business environment are being discussed although the actual implementation remains a challenge.

4.3 Denmark

After one and a half years of implementation, Denmark has in general made good progress in addressing the two policy challenges that were identified in the country-specific part of the BEPGs. Progress has been good in addressing the challenge of ensuring an adequate labour supply in view of the ageing of the population. As regards the recommendation to make work pay, the labour market initiative implemented in 2003 included more result-oriented activation measures as well as tightened availability and willingness-to-work criteria, while the tax reform, which lowers marginal tax rates for medium-income earners, was fully implemented in 2004 instead of gradually as originally envisaged. Concerning the recommendation to ensure expenditure control at all levels, although the overall targets so far have been exceeded, the measures adopted seem to have been effective in setting public consumption growth at local government level on a downward trend.

Good progress has also been made in addressing the challenge on enforcing competition in certain sectors and on improving public sector efficiency. As regards the recommendation to step up competition in sectors where this is inadequate, long term targets have been set for reducing the number of such sectors and by conferring extra powers on the Danish Competition Authority. As a step towards meeting the recommendation on increasing the efficiency of the public sector, an initiative was launched to investigate how public sector functions can be modernised and where possible delegated to the private sector.

4.4 Germany

After one and a half years of implementation, Germany has in general made some progress in addressing the four policy challenges that were identified in the country-specific part of the BEPGs. In particular, good progress has been made in addressing the challenge of promoting job creation and adaptability and mobilise unutilised employment potential. Significant action was taken to reform the tax benefit system to strengthen incentives to take up work, notably through implementing the various Hartz labour market reforms, which have started to show first measurable results. Good efforts have also been made to improve the efficiency of ALMPs and of job search assistance through the reform of the labour agency. No significant action however has been taken by the government to ensure that wages reflect productivity differences across skills and regions, besides encouraging social partners to make greater use of opening clauses in collective agreements.

Limited progress has also been made in addressing the challenge of increasing productivity through improvements in the business environment and the efficiency of the education system. The ban on special sales in the retail sector was lifted and German competition law was brought in line with European legislation. However, there is little visible progress in the reduction of the regulatory and administrative burden or in reducing employment protection. In the education system, some measures were taken to provide for more all-day schools and through the introduction of assistant professorships at universities.

Limited progress has been made in addressing the challenge on public finances, in particular by keeping the general government deficit below 3% of GDP. The government deficit in 2004, projected at close to 4% of GDP, remains well above that mark. It also means that the cyclically-adjusted deficit actually deteriorated in that year, albeit for reasons mostly outside of government control.

Some progress has also been made in addressing the challenge to secure the long-term sustainability of public finances, in particular by promoting the take-up of supplementary pension schemes and improving the efficiency of the health care system. While the law on sustainable funding of the pension system effectively leads to a lower annual increase in public pensions, the incentives for later retirement were only partially strengthened, in particular as the statutory retirement age was not increased. Health care reforms introduced some modest incentive to rein in consultation of doctors through the introduction of a small co-payment.

4.5 Estonia

After half a year of implementation, Estonia is making some progress in addressing the four challenges that were identified in the country-specific part of the BEPG. In particular limited progress is being made in addressing the challenge of the sizeable current account deficit, including through an appropriate fiscal policy stance. While remaining in a position of budgetary balance or surplus over the foreseeable future, the reduction of public savings in 2004 might not have sufficiently supported the correction of the external imbalance. The current account deficit is projected to remain virtually unchanged around 13 per cent of GDP in 2004, and to start declining only gradually thereafter on the back of an improving trade balance.

Good progress is being made in addressing the challenges of the structural problems in the labour market, namely to adopt policies with particular emphasis on re-integrating the long-term unemployed and to encourage social partners to ensure that wage developments do not hinder employment growth. An active labour market policy package, funded also by EU transfers, was approved by the government in autumn 2004, which aims at increasing the incentive for the long-term unemployed to actively look for jobs. Employment ratios should be increased both by reforms to the vocational training system, and by a reduction of taxes and social charges on labour. The fairly flexible labour market is characterized by a small role for collective wage bargaining. The minimum wage, however, is set at national level. In 2004, it stood at just 32% of the average national wage. Major income tax cuts and a stepwise increase to the threshold for income tax exemption will reduce non-wage labour costs considerably, thus taking pressure from gross wage settlements. Consequently, labour market conditions are set to continue to improve gradually.

Limited progress is being made in addressing the challenge of improving conditions for increasing productivity. Efforts have been made to promote R&D but overall levels, especially the business share of R&D, remain low. Important efforts are being made to improve the vocational training system, but few new measures have been taken to improve the educational system over the past six months.

Good progress is being made in addressing the challenge of developing effective competition in network industries. Some efforts have been made to further open up the electricity market to competition, and competition is effectively improving in the telecommunications market. So far, no measures have been announced to strengthen the independence of regulators.

4.6 Greece

After one and a half years of implementation, Greece has in general made only limited progress in addressing the three policy challenges that were identified in the country-specific part of the BEPGs. In particular, no progress has been made regarding the challenge on the long-term sustainability of public finances. Despite strong economic growth, no actions were taken by the Government to reduce the debt ratio at a satisfactory pace and to correct the excessive deficit, in response to Article 104(7) adopted by the Council on 4 July 2004. In cyclically-adjusted terms, Greece moved further away from a budgetary position of close to balance or in surplus. The impact of measures aiming to improve labour productivity and enhancing working capacity of the unemployed is as yet unclear while measures undertaken by the government in the framework of the reform the social security system are insufficient to avoid budgetary strains in the future due to the problem of ageing population.

Some progress has been also made in addressing the challenge on increasing the low level of productivity. Initiatives to encourage the transition towards a knowledge based society have been pursued. However effective competition in the electricity market is not yet secured despite steps in the right direction. In addition, while efforts have been made to simplify the business and taxation environment, the transposition rate of internal market directives has decreased.

Finally, limited progress has been made in addressing the challenge of reducing the high rate of structural unemployment, and increase employment rates, particular for women. Measures to ensure that wages reflect productivity differentials in the framework of the wage bargaining process are rather insufficient as benchmark wages are still linked to the announced income policy in the public sector and to inflation prospects. The impact of the measures that government has undertaken to promote part-time work and to promote flexibility and to better much demand and supply is as yet unclear, given the still high barriers to entry and the strong rigidities in the Greek labour market.

4.7 Spain

After one and a half years of implementation, Spain has in general made some progress in addressing the three policy challenges that were identified in the country-specific part of the BEPGs. In particular, some progress has been made in addressing the challenge on raising the low employment rates. Although tax incentives were introduced in 2003 to promote female participation and provision of child care as well as geographical mobility, only limited measures on housing have been implemented in 2004. Moreover, the wage bargaining system remains broadly unchanged and no reform of the employment protection legislation so as to reduce the labour market segmentation has been undertaken.

Some progress has been made in addressing the challenge of increasing the low level of productivity. Initiatives have been taken to encourage R&D investment and ICT take-up, but additional action will be needed to improve the education system. Effort has been made to reduce the administrative burdens on businesses but the measures taken so far to further enforce competition in certain sectors, namely, retail and electricity, have been insufficient.

Finally, limited progress has been made regarding the challenge on the long-term sustainability of public finances. Measures aiming to increase employment rates, the endowments to the Pension Reserve Fund expected to amount to 2.9 per cent of GDP in 2005 and the fast reduction of public debt below 50 per cent of GDP are positive steps so as to tackle the budgetary impact of ageing. However, no reform of the public pension system, strengthening the link between contributory efforts and pension benefits, is envisaged.

4.8 France

After one and a half years of implementation, France has in general made some progress in addressing the four policy challenges that were identified in the country-specific part of the BEPGs. Limited progress has been made in addressing the challenge of reducing rapidly the general government deficit to below 3 per cent of

GDP and keeping government finances on a steady consolidation path. However, while the deficit is likely to be brought to 3 per cent of GDP in 2005, this is owed largely to a better macroeconomic environment than initially envisaged and to the implementation of one-off measures amounting to ½ percentage point of GDP in 2005. Despite these one-off measures, the cumulated reduction in the cyclically-adjusted deficit over 2004-2005 will be lower than recommended. Finally, efforts envisaged by the French authorities for the medium-term, although consistent with the minimum of 0.5 percentage point of GDP per year, are not sufficient to bring government finances in a close to balance or in surplus situation in 2008, the end-year of the projection period.

Limited progress has been made in addressing the challenge on labour market participation and structural unemployment. Despite the implementation of the pension reform, incentives to work remain relatively weak for people at and above the legal retirement age, which is moreover at 60 among the lowest in the OECD. In addition, incentives to job search remain relatively low, and little has been done so far to alleviate employment protection legislation, which is particularly strict in France.

By contrast, good progress has been made in addressing the challenge on the long term sustainability of public finances. After the implementation, in 2003, of a comprehensive reform of the pension system, a reform of the health insurance system was introduced in 2004, with the aim to balance its budget. Although the precise budgetary impact of the reform remains uncertain, especially on the expenditure side, this reform constitutes a clear step in the right direction.

Finally, there has been some progress in addressing the challenge on productivity and business dynamism. Measures have been taken to reduce and simplify business regulations. Efforts have been made to increase competition in energy markets but effective competition remains limited. Further progress should also be made to raise the transposition rate of internal market directives and to bring down the number of infringement proceedings.

4.9 Ireland

After one and a half years of implementation, Ireland has in general made good progress in addressing the policy challenge that was identified in the country-specific part of the BEPGs, regarding the achievement of a smooth transition to lower, sustainable growth levels in the years ahead. In particular, further efforts have been made to improve control and efficiency of public expenditure, especially by extending multi-annual budgeting and by reforms in the health sector. As regards wage developments, relatively moderate provisions were agreed by the social partners in June 2004 in the new 18-month national wage agreement. Efforts have been pursued to improve infrastructure and to raise the level of R&D. However, action has been more limited with regard to increasing competition in network industries and certain other sectors of the economy.

4.10 Italy

After one and a half years of implementation, Italy has in general made limited progress in addressing the five policy challenges that were identified in the country-specific part of the BEPGs. In particular, limited progress has been made in addressing the two challenges for public finances. While narrowly avoiding the occurrence of an excessive deficit, the underlying budgetary position worsened in 2004 and the Italian Government continued to rely mainly on temporary measures. Attempts to strengthen the policy co-ordination continue to show mixed results on different levels of government. The planned reduction of the tax burden for 2005 and 2006 is not fully financed through structural cuts in current primary expenditure.

Progress in addressing the long term sustainability challenge of public finances was also limited. Specifically, the efforts made to ensure a satisfactory pace of debt reduction proved insufficient in 2004, in spite of sizeable privatisation proceeds. Conversely, the Parliament adopted a pension reform applying stricter provisions yet taking effect only in 2008.

Some progress has been made in addressing the challenge on labour market and regional development. Action was taken to increase labour force participation mainly via the introduction of additional, more flexible labour contracts. Very modest provisions for child-care facilities were blocked by the Constitutional court. As a step towards a more decentralised wage setting mechanism the government has supported the dialogue among social partners. By contrast, no measures were taken to further reform employment protection legislation and to improve the efficiency of unemployment benefit and social assistance system.

Limited progress has been made in addressing the challenge on the knowledge-based economy. Although some reforms of the school system and universities have been implemented, the education and skills statistics still place Italy below the EU average. Similar conclusions hold for the innovative capacity. Furthermore, the ICT use and diffusion, in particular for small and medium firms, has not been sufficiently promoted.

Some progress has been made in improving business environment. Efforts initiated in 2003 have been continued to simplify the regulatory framework, and the access to finance improved procedure. However, progress has been more limited with regard to increasing effective competition in the service sector and energy sector, and the transposition rate of internal market directives has decreased. The electricity sector has been the subject of some reforms; however the competition in both electricity and gas sector is not effective yet.

4.11 Cyprus

After half a year of implementation, Cyprus is making good progress in addressing the two policy challenges that were identified in the country-specific part of the BEPGs. In particular, good progress is being made in addressing the challenge on ensuring a reduction of the general government deficit on a sustained basis, namely through the implementation of the convergence programme, which, given the positive results in the development of government revenues and expenditure in the first 8 months of 2004 and the measures included in the 2005 budget, has been -more or less- on track so far.

Good progress has also been made in addressing the challenge of increasing the diversification of the economy towards higher value added activities. Several initiatives to improve the adequacy of skilled human capital and to promote R&D, innovation and ICT diffusion in order to encourage the transition towards a knowledge based society were launched. Furthermore, efforts have been made to simplify the business and taxation environment, through the implementation of e-government services, by shifting the tax burden from direct to indirect taxes (in line with the *acquis*), and reducing entry barriers in several sectors.

4.12 Latvia

After half a year of implementation, Latvia is making limited progress in addressing the four policy challenges that were identified in the country-specific part of the BEPGs. In particular, no progress is being made in addressing the challenge of the sizable current account deficit, to which an appropriate fiscal policy should contribute. Although general government budget revenues, owing to strong growth achieved in 2004, have been better than foreseen in the 2004 budget, no effort seems to have been made to reduce the general government deficit, notwithstanding the recommendation in this regard: August 2004 budget amendments provided for additional expenditure worth nearly 1 per cent of GDP, while the deficit target for 2004 remained unchanged.

Some progress is being made in addressing the challenge to improve conditions for increasing productivity. Regarding the recommendation to improve the education and training systems, some plans have been issued but without focusing on the key problem of responsiveness to labour market needs. Significant efforts are being made to promote R&D and innovation and to support the use of new technologies. However, the encouragement of entrepreneurship still faces administrative, financial and cultural barriers.

Some progress is also being made as regards the challenge to address structural problems in the labour market. The tax and benefit system is being revised to make work pay more, most notably, via increase in the minimum tax-free threshold. However, there has been limited effort to strengthen labour supply by pursuing efforts to better adapt the qualifications of the workforce to the requirements of the labour market and by facilitating labour mobility.

Finally, some progress is being made to address the challenge to develop effective competition in network industries. Latvia is late in implementing the EU energy directives, effective competition in the energy market remains low and the role of the regulator still needs to be strengthened. Nevertheless, announced plans for interconnections with other European network mark a positive step.

4.13 Lithuania

After half a year of implementation, Lithuania is making some progress in addressing the four policy challenges that were identified in the country-specific part of the BEPGs. In particular, good progress is being made in addressing the structural problems in the labour market, namely through the implementation of active labour market policies and infrastructure development. Several measures to improve the combined incentive effects of taxes and benefits are under preparation, and other key measures are expected to be taken in the remainder of 2004.

Some progress is being made in addressing the challenge on the public finances. The general government deficit in 2004 was slightly below the government target presented in Lithuania's first convergence programme. Additional revenues were used to finance further expenditure, but this happened in the first half of the year.

Some progress is being made in addressing the challenge and recommendations on productivity and business dynamism. Important efforts are being made to improve vocational trainings although few new measures have been taken to improve the educational system. Actions have been taken to promote R&D and innovation and to support the use of new technologies.

Finally good progress is being made in addressing the challenge of developing competition in the network industries. A set of reforms have been taken to further liberalise network industries and projects are starting to improve interconnection capacities.

4.14 Luxembourg

After one and a half years of implementation, Luxembourg has made some progress in addressing the two policy challenges that were identified in the country-specific part of the BEPGs. Progress made in addressing the challenge on increasing the activity and employment rates of the resident population by drawing inactive people, especially older ones, into the labour market has been limited. The main measures in this field had already been taken in 2002, with little further progress recorded since then. The Luxembourg pension system continues to provide few incentives to older workers for remaining at work when they have reached an age where they are entitled to a complete pension.

Good progress has been made in addressing the challenge of improving the business environment and encouraging on entrepreneurship. The modernisation of the legislative framework for competition, policy has been finalised in May 2004. However, it is important to continue to monitor its implementation. Efforts to reduce the administrative burdens on businesses have been pursued.

4.15 Hungary

After half a year of implementation, Hungary is making limited progress in addressing the five policy challenges that were identified in the country-specific part of the BEPGs. In particular, insufficient progress is being made in addressing the challenge of ensuring a reduction of the general government deficit on a sustainable basis. Despite some consolidation, the deficit target in 2004, which was to be the anchor of the fiscal adjustment until 2008, has been missed. Also the reform measures included into the 2005 budget seem not sufficient to achieve the path for deficit reduction specified in the convergence programme and endorsed by the Council.

Some progress is being made in addressing the challenge posed by structural problem in the labour market. As a step towards the improvement of the mobility of labour force, the enhancement of the motorway network should improve the accessibility of the Eastern regions of the country in the medium term. However, it remains to be seen to what extent the changes in the housing policy will contribute to higher mobility. The authorities have, furthermore, adopted several measures in order to integrate disadvantaged persons into the labour market, although a consistent framework for such employment policy measures is not yet evident. While there was only limited progress in ensuring that the tax and benefit system supports employment and the entering into the labour market, further efforts have been made with the changes in the tax wedge, coming in force in limited progress is being made in addressing the challenge of policies inducing wage moderations. In 2004 the slowdown in real wage growth below productivity growth was largely induced by strong demonstrative effects from public wage growth. However, no progress was made in order to enforce central-level social dialogue.

Some progress is being made in addressing the challenge on productivity and business dynamism. Measures have been taken to create a business environment more supportive to entrepreneurship, and, in particular, measures to reduce the administrative burden and to facilitate access to credit have been taken in favour of SMEs. The education system is improving but is not yet efficient enough. Further efforts have also to be made to speed up the movement towards the knowledge based economy.

Finally, limited progress is being made in addressing the challenge on developing effective competition in network industries. Competition has improved, but the market is still dominated by incumbents and the independence of the regulator in energy market is not guaranteed.

4.16 Malta

After half a year of implementation, Malta is making limited progress in addressing the three policy challenges that were identified in the country-specific part of the BEPGs. In particular, good progress is being made in addressing the challenge of putting public finances on a sustainable basis. The measures adopted in the 2004 budget are likely to reduce the general government deficit to 5.2 per cent of GDP in 2004, in compliance with the target set up in the May 2004 convergence programme.

Limited progress, however, is being made in addressing the challenge of increasing in employment rates, especially among women. While no actions were taken to streamline the tax-benefit system interaction and to facilitate the return to work of middle-age women, the outcome of the measures undertook to improve the quality of secondary education and vocational training are not yet visible.

Limited progress is also being made in addressing the challenge on encouraging effective competition, namely in sectors such as network industries, food industries, and shipbuilding. The government has continued to pursue efforts to provide the right environment for competition to develop but progress is slow.

4.17 Netherlands

After one and a half years of implementation, the Netherlands has in general made good progress in addressing the three policy challenges that were identified in the country-specific part of the BEPGs. In particular, very good progress has been made in addressing the challenge on budgetary adjustment, where corrective measures of a mainly structural nature have been taken in order to correct the excessive deficit that arose in 2003, that would help.

Good progress has also been made in addressing the challenge on drawing inactive people into the labour market, namely through a far-reaching overhaul of the social security and pension systems, with, however, some question-marks remaining on the effectiveness of certain measures in actually raising the participation rate.

Finally, some progress has been made in addressing the challenge of tackling the relative slow productivity growth. Measures have been taken to strengthen the Dutch Competition Authority and to address competition problems in some sectors of the economy. Quantified targets for a reduction of the administrative burden will be set up in 2005. In an attempt to increase business investment in R&D, some efforts have been made to stimulate the links between industries and universities. Science and technology education have been promoted by different programmes.

4.18 Austria

After one and a half years of implementation, Austria has in general made some progress in addressing the three policy challenges that were identified in the country-specific part of the BEPGs. Some progress has been made in addressing the challenge on the long-term sustainability of public finances, namely through reforming the pension system. Ambitious reforms were implemented in 2004, but adjustments to be implemented in 2005 appear to take back some of the effects. Insufficient progress was made in achieving expenditure savings across various levels of government, notably as the granting of a fiscal investment premium led to slippage from expenditure targets. The ongoing tax reform is therefore not financed by structural measures on the expenditure side.

Good progress has been made in addressing the challenge to improve the technology base and to encourage business R&D. A streamlined government support system appears to show first results insofar as Austria is closing the innovation gap vis-à-vis the EU average.

Limited progress has been made in addressing the challenge of strengthening the development of effective competition in some sectors. Despite measures to increase effective competition in, for example, the retail sector and falling mark-ups in network industries, barriers to entry in the electricity market seem to remain. Also, staffing of the competition authority has been too low. The law on telecommunications adopted in August 2003 strengthened the position of the telecommunication authority.

4.19 Poland

After half a year of implementation, Poland is making some progress in addressing the five policy challenges that were identified in the country-specific part of the BEPGs. In particular, limited progress is being made in addressing the challenge regarding the labour market. Some measures were taken to reduce the disincentives to work associated with the current benefit systems but they need to be complemented by more substantial reforms, and no progress was made in lowering the high tax burden on labour. As a first step towards increasing the flexibility of the wage-setting process, the government has introduced a measure allowing firms to hire job starters at a discount to the minimum wage, but more needs to be done to allow the minimum wage to decline relative to average wages so as to reduce the cost to firms of hiring low-skilled workers. Furthermore, while further efforts have been made to improve the education and training system, little action has been taken to remove the barriers to labour mobility.

Some progress is being made in addressing the challenge on public finances. Good progress is being registered in reducing the general government deficit in the context of the budgetary surveillance exercise in line with the decisions taken by the Council on 5 July 2004. Only limited progress, however, has been achieved in addressing the issue of long-term sustainability of public finances. The implementation of the reform of the pension system is constantly monitored. Still, important risks remain stemming from the rising stock of contingent liabilities.

Some progress is being made concerning the challenge of improving the conditions for increasing productivity. Good progress is being made to adapt the education and training system to the labour market requirements, namely by promoting investment in training and lifelong learning, developing entrepreneurial potential and ICT skills. However, further effort is necessary to improve the field of R&D and innovation, despite some measures aiming at the transfer of knowledge via IT and some targeted projects to spur the implementation of R&D results in the economy.

Regarding the challenge on speeding up the restructuring of the economy and privatisation in industry, limited progress is being observed. On the one hand, no progress has been made to reduce the overall level of State aid and reorienting it towards horizontal aid. On the other hand, limited progress is being made to encourage effective competition in network industries and speeding up the economic restructuring, except for the announced acceleration of privatisation in 2005.

Finally, good progress is being made in addressing the challenge of business dynamism. Legislative measures were pursued to reduce the administrative burden and improve the business environment, although their implementation is delayed.

4.20 Portugal

After one and a half years of implementation, Portugal has in general made some progress in addressing the three policy challenges that were identified in the country-specific part of the BEPGs. In particular, limited progress has been made in addressing the challenge on consolidation of public finances. In 2004, the Portuguese authorities succeeded in keeping the general government deficit below 3 per cent of GDP; however, Portugal relied, for the third consecutive year, on the raising of sizeable revenues from one-off operations to meet to meet that objective. Despite some improvement of the underlying deficit, it seems that the measures taken in 2004 were insufficient to avoid expenditure slippages in various sub-sectors of the general government. However, the programmes of structural reforms on areas such as public administration, education and health care have proceeded broadly as planned and are expected to support the intended medium-term budgetary consolidation.

Some progress has been made in addressing the challenge of increasing the overall competitiveness of the economy, namely through improving the education system, promoting investment in R&D, improving the business conditions of firms and enhancing competition in the energy sector. However, it remains uncertain whether the measures taken are sufficient to improve significantly the efficiency of the education system and to catch up in terms of business R&D spending and innovation as well as ICT diffusion and the rate of transposition of Internal Market directives has decreased.

Good progress has been made in addressing the challenge on long-term sustainability of public finances. The reform of the health sector is being implemented in line with plans. As a step towards reforming the pension system for civil servants, in 2004, the government made early retirement more costly and pension benefits less generous for new pensioners.

4.21 Slovenia

After half a year of implementation, Slovenia is making some progress in addressing the four policy challenges that were identified in the country-specific part of the BEPGs. In particular, good progress is being made in addressing the challenge on lowering inflation in a sustainable way, especially through applying forward-looking wage indexation schemes in both the public and the private sector while only little action was taken to step-up structural reforms aimed at liberalising administered prices.

Limited progress is being made in addressing the challenge on increasing employment rates, for older workers. As a step forward towards facilitating the participation of groups furthest from the labour market, which include older, long-term unemployed and young people, the government introduced several changes in the tax system but took no measures to address the imbalance between temporary and permanent working conditions. Further improvement is required in developing a comprehensive active ageing strategy consisting of financial incentives, flexible work arrangements and access to lifelong learning activities for older workers.

Some progress is being made in addressing the challenge to improve conditions for sustained productivity growth. Steps have been taken to reduce the administrative barriers facing new business, including the partial completion of the one-stop-shop service for small businesses. In 2004, tax incentives encouraging investment were introduced, in particular for firms that hire PhD graduates and invest in equipment for research and technological development. In addition, the decision was taken to establish eight to nine centres of research excellence.

Limited progress is being made in addressing the challenge to promote the development of effective competition in the economy, notably in network industries. The Competition Protection Office is still understaffed and fines for anticompetitive behaviour are too low to act as a deterrent. Liberalisation of the network industries continues but at a different intensity across sectors. Limited steps have been taken to facilitate the purchase of land for industrial use.

4.22 Slovakia

After half a year of implementation, Slovakia is making good progress in addressing the four policy challenges that were identified in the country-specific part of the BEPGs. In particular, good progress is being made in addressing the challenge regarding the further reduction of the general government deficit on a sustainable basis. Effective action was taken to achieve the 2005 deficit target of the May 2004 convergence programme and to implement with vigour the measures envisaged in the programme, including those related to a systemic pension reform, further health care reforms and public sector rationalisation. However, the authorities would seemingly have had some additional opportunities to accelerate the fiscal adjustment and should demonstrate a strong commitment to seize such opportunities in future, in particular as growth will prospectively be more favourable than expected in the convergence programme.

Good progress is being made in addressing the deep-seated structural problems in the labour market, although unemployment remains high as economic restructuring continues. Further efforts have been made to strengthen labour supply, including by removing obstacles to regional mobility and reducing skill mismatches (e.g. through continued improvements to the transport infrastructure and the functioning of the housing market and through active labour market policies). Steps have been taken to generate additional labour demand, including by allowing for more flexibility in the wage setting (e.g. limited increase of minimum wages). Steps have been implemented to create conditions for an affordable reduction in the health care and social contribution rates (e.g. health care and pension reforms).

Good progress is being made in addressing the challenge on business environment and entrepreneurship. The legislative framework has been improved. In particular a new bankruptcy legislation has been introduced and a reform of the tax system has led to a decrease in the corporate tax rate. However, weak legal enforcement remains a problem.

Limited progress is being made in addressing the challenge on improving conditions for increasing productivity. The education reform is in its early stages with reforms of the tertiary education still being discussed. Progress on R&D and innovation and transfer of knowledge, despite significant FDI inflows, has been limited. However, the government has recently approved a strategy to speed up the transition to the knowledge-based society. Also, information technologies are spreading.

4.23 Finland

After one and a half years of implementation, Finland has in general made good progress in addressing the two policy challenges that were identified in the country-specific part of the BEPGs. Some progress has been made in addressing the challenge on labour market, as the progress on tightening of the eligibility criteria and improvement of the administration of benefit systems is still lacking. Also, no progress has been made in improving incentives in benefit systems. On the positive side, taxes on income have been cut and the employment rate of older workers has risen. Moreover, the measures introduced in the government's inter-sectoral employment programme have produced some early results. Allowing wages to better reflect productivity differences depends on the outcome of the new wage agreement.

Good progress has been made in addressing the challenge to enhance competition in certain sectors and improve the efficiency of the public sector. In 2004, Finnish competition law was brought in line with the new EU rules and a research institute on competition was created. However, no measures have been taken to deal with the excessive market concentration in the electricity sector. The action plans to improve the efficiency of the public service sector and to increase the efficiency of the public procurement process are being implemented. In addition, mechanisms to help control public spending have been put into operation. On the central government level, multi-annual spending limits have helped to control spending and ensure the compliance of expenditure rules. In their first year in operation, in 2004, final expenditure remained below the spending limit, and also the 2005 budget proposal is within the ceiling.

4.24 Sweden

After one and a half years of implementation, Sweden has in general made limited progress in addressing the two policy challenges that were identified in the country-specific part of the BEPGs. Limited progress has been made in addressing the challenge on labour supply through pursuing further reform of the tax and benefit systems to improve work incentives. Measures to promote participation for certain groups have been taken although other initiatives may have a negative effect. As regards tax and benefits a mixed picture emerges notwithstanding further steps to complete the income tax reform taken in the Budget Bill for 2005.

Limited progress has also been made in addressing the challenge on enhancing competition in certain sectors and improving the efficiency of the public sector. Despite some efforts in the right direction, there is little evidence of increased efficiency in the public sector or of measures taken in order to improve competition in non-tradable sectors.

4.25 United Kingdom

After one and a half years of implementation, the United Kingdom has made good progress in addressing the four policy challenges that were identified in the country-specific part of the BEPGs. Some progress has been made in addressing the challenge to improve the relatively low level of productivity. While competition in specific sectors such as professional bodies has improved, less progress has been made in the deregulation of pharmacies and the liberalisation of postal services. Official evaluation of efforts to boost both public and private R&D and innovation has been limited. Work is ongoing to improve basic workforce skills, with initiatives to strengthen apprenticeships and facilitate adult learning.

Good progress has been made in addressing the challenge of reducing the high numbers claiming sickness and disability benefits and sustaining longer-term labour supply. The government has recently announced a major extension of existing pilot projects to support the return to work of benefits claimants.

Good progress has been made in addressing the challenge to improve the quality and efficiency of public services. Reforms are being been made to ensure that increased public spending is used efficiently and cost-effectively, building on the existing output-focused role of public service agreements.

Finally limited progress has also been made in addressing the challenge added in 2004 on strengthening the budgetary position so as to avoid emerging budgetary imbalances. Notwithstanding some signs of budgetary improvement relative to the deficit of 3.4 per cent of GDP in 2003, substantial uncertainties exist and it remains too early to conclude that imbalances are being avoided.

ANNEX I

Box 1: Follow-up to country specific recommendations related to public finances			
	Country Specific Recommendations (as an extension of general Guidelines no. 1, 14-15)	**Significant Measures in 2004**	
		Adopted	**Proposed**
GUIDELINE 1: Reach or maintain budgetary positions of close to balance or in surplus throughout the economic cycle*; correct excessive deficits in line with the Stability and Growth Pact (*Euro area Member States were recommended to improve their cyclically-adjusted balance by at least 0.5 per cent of GDP annually in case the medium-term objective had not yet been achieved)			
CZ	Reduce the general government deficit in a credible and sustainable way within a multi-annual framework.	The deficit targets for 2004 and 2005 are likely to be achieved. A law on new budgetary rules which introduced fiscal targeting based on medium-term expenditure ceilings for central government adopted in summer 2004.	
DE	Achieve an annual reduction in the cyclically-adjusted deficit of 0.6% of GDP in 2004 and at least 0.5% in 2005 to ensure the general government deficit is brought below 3% of GDP in 2005; should the recovery be stronger than expected, allocate revenues to deficit reduction.[30]	Despite expenditure being kept under firm control, the cyclically-adjusted deficit is estimated to have widened by 0.4% of GDP in 2004, reflecting weak tax revenues. In 2005, a decline in the cyclically-adjusted balance by 0.5 percentage points of GDP is expected though, under current policies, Germany is unlikely to bring its deficit below 3% of GDP in 2005. In 2006, the deficit is expected to fall below 3% of GDP on current polices.	The German authorities have recently announced additional savings for 2005, which could bring the general government deficit below 3 per cent of GDP in 2005.
EE	Avoid pro-cyclical fiscal policies that may exacerbate the external imbalance; promote the reduction of the gap between domestic savings and investment.	The fiscal expansion was untimely in view of accelerating activity in 2004. For 2005, the authorities plan a balanced budget implying further, albeit much lower, fiscal easing.	
EL	Respond appropriately to possible excessive deficit; move towards medium-term budgetary position close to balance or in surplus by improvements in cyclically-adjusted budget balance of at least 0.5% of GDP per year.	No effective action has been taken to correct the excessive deficit in 2004, reflecting the pro-cyclical, expansionary nature of Greek fiscal policies. The cyclically-adjusted budget balance is projected to improve significantly in 2005 as the government is expected to control - but insufficiently - current primary spending.	
FR	Achieve an annual reduction in the cyclically-adjusted deficit of 0.8% of GDP in 2004 and at least 0.6% in 2005 to ensure the general government deficit is brought below 3% of GDP in 2005; should the recovery be stronger than expected, allocate higher revenues or savings from lower than expected expenditure to deficit reduction.[31]	The improvement in the cyclically-adjusted balance in 2004, of 0.3% of GDP, reflects no additional measures taken in 2004, despite a stronger-than-expected economic recovery. In 2005, an expected decline in the cyclically-adjusted balance by 0.7 percentage point of GDP is influenced significantly by one-off revenues. This contributes to a projected reduction of the deficit to 3.0% of GDP in 2005. In 2006, a deficit higher than 3% of GDP is expected on current policies.	
IT	Move towards a close to balance or in surplus position by reducing the cyclically-adjusted deficit by at least 0.5% of GDP per year, replacing one-off measures with more permanent measures.	The worsening of the fiscal position, at 3.0% of GDP in 2004, results from a gradual reduction of one-off measures, coupled with no adjustment to the primary expenditure to GDP ratio. The cyclically-adjusted budget balance worsened by 0.5 percentage point of GDP in 2004 and is projected to worsen further in 2005.	
CY	Reduce the general government deficit in a credible and sustainable way within a multi-annual framework.	The 2004 deficit target is likely to have been met and Cyprus is broadly on track to reach the target for 2005.	
LV	Reduce the general government deficit in a credible and sustainable way within a multi-annual framework.	The deficit target for 2004 remained unchanged at 2.0% of GDP, despite significantly higher output growth and tax revenues, which should have led to a tighter target.	The rejection of the 2005 budget caused the government to resign in October; hence the future direction of fiscal policy is uncertain.

[30] Recommendation 7 bis to Germany also referred to budgetary consolidation after 2005.
[31] Recommendation 3 to France also referred to budgetary consolidation after 2005.

Box 1: Follow-up to country specific recommendations related to public finances (continued)			
Country Specific Recommendations (as an extension of general Guidelines no. 1, 14-15)		**Significant Measures in 2004**	
		Adopted	**Proposed**
GUIDELINE 1: Reach or maintain budgetary positions of close to balance or in surplus throughout the economic cycle*; correct excessive deficits in line with the Stability and Growth Pact (*Euro area Member States were recommended to improve their cyclically-adjusted balance by at least 0.5 per cent of GDP annually in case the medium-term objective had not yet been achieved)			
LT	Reduce the general government deficit in a credible and sustainable way within a multi-annual framework; avoid pro-cyclical policies, in particular, budget amendments allocating additional expenditure in response to higher than expected revenue.	The deficit for 2004 is likely to have been lower than targeted and the target for 2005 is likely to be met. A budget amendment allocating additional expenditure (0.3% of GDP) was adopted in June 2004 and no major budget amendments have been made since July 2004.	
HU	Reduce the general government deficit in a credible and sustainable way within a multi-annual framework.	Corrective measures taken in 2004 were insufficient to reach the agreed deficit target of 4.6% of GDP, and the failure to achieve the target can not be attributed to unexpected unfavourable economic circumstances. The agreed target for 2005 is not expected to be reached, indicating a significant departure from the agreed adjustment path.	
MT	Reduce the general government deficit in a credible and sustainable way within a multi-annual framework.	The deficit for 2004 is likely to have been lower than targeted. New measures in the 2005 budget to increase fiscal stringency suggest that Malta is broadly on track to reach the target for 2005.	
NL	Stand ready to take necessary measures in response to an excessive deficit, while continuing to contain government expenditure within clearly defined ceilings set in real terms, consistent with a medium-term budgetary position close to balance or in surplus.	In order to reduce the deficit, a supplementary package of savings equivalent to 0.6% of GDP was implemented in April 2004; around half of these measures were of a one-off nature. As a consequence, the general government deficit is expected to have fallen to 2.9% of GDP in 2004. The 2005 budget contains consolidation measures equivalent to around half a percentage point of GDP.	
AT	Achieve structural expenditure savings, also at lower levels of government, to lower the high tax burden, while securing a cyclically-adjusted budgetary position close to balance.	The rise in the deficit in 2004 was mainly due to lower-than-planned expenditure restraint at both central and lower levels and also influenced by the first stage of a income tax reform. The second stage of the tax reform in 2005, costed at 0.8 percentage points of GDP, is not offset in the Budget and contributes to a significant deterioration in the cyclically-adjusted balance in 2005.	
PL	Reduce the general government deficit in a credible and sustainable way within a multi-annual framework.	The deficit for 2004 is likely to have been lower than targeted, with higher-than-expected revenues used to consolidate the fiscal position. The draft budget for 2005, adopted by the government at the end of September, incorporates several measures included in the Hausner plan, suggesting that Poland is on track to meet the target for 2005.	
PT	Avoid the deficit breaching 3% of GDP again; move towards a medium-term close to balance or in surplus position by ensuring an improvement in the cyclically-adjusted budget balance of at least 0.5% of GDP per year, replacing one –off measures by measures of a more permanent character.	The deficit for 2004 is likely to be below 3% of GDP, influenced by sizeable one-off measures (of 2% of GDP). The cyclically adjusted deficit was unchanged in 2004. On current policies, a worsening of the cyclically adjusted, as well as the nominal, balance is likely in 2005.	
SK	Reduce the general government deficit in a credible and sustainable way within a multi-annual framework.	The deficit for 2004 is likely to have been lower than targeted and the target for 2005is likely to be met.	
UK	Avoid the occurrence of an excessive deficit; improve the cyclically-adjusted position to consolidate public finances, consistent with a position of close to balance or in surplus in the medium term.	The deficit for 2004 is likely to have been lower than in 2003 and below 3% of GDP. A further reduction of the deficit is projected in 2005. An improvement of the cyclically adjusted balance is foreseen in 2004 and 2005.	

Box 1: Follow-up to country specific recommendations related to public finances (continued)			
	Country Specific Recommendations (as an extension of general Guidelines no. 1, 14-15)	Significant Measures in 2004	
		Adopted	Proposed
	GUIDELINE 14: Enhance the contribution of the public sector to growth		
CZ	Reform the health care system.		
DK	Ensure expenditure control at all levels of government.	Targets for public expenditure growth have been exceeded but there are indications that a more effective control of public expenditure has been established.	
EL	Effective control of Government current primary spending; use public resources more effectively.		
FR	Curb the dynamics of spending in the health sector.	Reform adopted, with the aim of bringing the Health insurance system into balance in 2007 while preserving the quality of the health service.	
IE	Enhance public expenditure efficiency; improve medium-term revenue and expenditure planning.	Initiatives to improve efficiency and control of expenditures	
PO	Obtain deficit reduction through expenditure side; increase health-care system efficiency.		Draft budget for 2005 will rationalise and retrench public expenditure;
SK	Additional health systems reform and public sector rationalisation.	Budget 2005 incorporates last tranches of current health care reform agenda and further measures for public sector rationalisation.	
FI	Improve spending control; ensure compliance with expenditure rules.	Mechanisms to help control public spending are being implemented	
UK	Ensure efficient and cost-effective delivery of public services.		Building on publication of a major review of public sector efficiency, government departments have submitted plans to achieve significant annual efficiency savings
	GUIDELINE 15: Ensure a further decline in government debt ratios		
BE	Ensure a sustained declining trend of the debt ratio by maintaining high primary surpluses.	The primary surplus, while decreasing over the last few years, remains high and contributes to a decline in the debt ratio, being 95.8% in 2004.	
EL	Ensure a sustained declining trend of the debt ratio by maintaining high primary surpluses.	The primary surplus has declined over the past five years and reached its lowest level in 2004. Despite strong economic growth the debt ratio is estimated to have increased in 2004 to 112.2 per cent of GDP. A decline in the debt ratio in 2005 will be influenced by the success of the privatisation programme.	
IT	Ensure that the debt ratio is diminishing at a satisfactory pace towards the 60% of GDP threshold.	The primary surplus has been on a declining trend over the past five years and reached its lowest level in 2004. The still very high debt to GDP ratio continues to decline at a slow pace, to 106.0% of GDP in 2004, largely explained by the high levels of the cash borrowing requirement, which since 1999 has consistently exceeded the Maastricht definition of general government deficit.	
PL	Reduce the risk from the rising stock of contingent liabilities.	The pension reform was implemented in 1999 and the pension system is stable. Limited progress has been made in other areas, such as health-care, education and transport.	

Box 2: Follow up to country specific recommendations related to labour markets			
Country specific recommendation (as an extension of general Guidelines no. 4-8)		**Significant Reform Measures in 2004**	
		Adopted	**Proposed**
GUIDELINE 4: Improve the combined incentive effects of taxes and benefits and reduce high marginal effective tax rates			
CZ	Enhance incentives to work and lower high social security contribution rates; reform tax-benefit systems to eliminate disincentives to work.	Higher unemployment benefits coupled with stricter eligibility conditions and work availability requirements; cut in sickness benefits coupled with stricter enforcement.	
BE	Reduce distortions to work incentives in tax-benefit systems.	Revised system of service vouchers; increased control on work availability requirements.	
DK	Improve labour supply incentives, in particular tax reform and eligibility rules.	Earned income tax credit, income tax reform lowering marginal tax rates for many workers; tightened job availability criteria.	
DE	Continue tax-benefit reforms to work incentives, enforce job-search conditionality.	Reduced benefit duration; end adjustment of benefits to wage increases; new benefit with strict work availability requirements.	
EE	Set up an effective institutional framework that supports job creation		Reduction of taxes and social charges on labour
EL	Improve formal work incentives, including part-time, through reduced non-wage costs and pension rights transferability.	Replacement of unemployment benefits with employment subsidies.	Subsidised employment
FR	Implement new unemployment insurance system, including effective job-search incentives.	Tightened eligibility conditions for unemployment benefit and reduced duration.	
IT	Increase labour force participation of women and older workers; increase resources and efficiency of unemployment benefit and social insurance system.		Mandatory participation in active measures to receive unemployment benefits
LV	Review the tax-benefit system in order to make work pay; increase the efficiency of social spending.		Action plan to combat undeclared work (2005-2009)
LT	Improve the combined incentive effects of taxes and benefits.		Overhaul of the unemployment benefit system; reduction of labour taxation
MT	Streamline the tax-benefit system to strengthen incentives to work.		
HU	Ensure that the tax –benefit system provides incentives to enter or remain in the labour market; reduce the high tax burden on labour.		Reduction in labour taxes; reform of health contribution; Measures in disability schemes envisaged
NL	Continue benefit reforms, particularly eligibility and conditionality and reform disability system.	Reduced benefit duration; job search requirement for older unemployed people.	Fiscal facilities for early retirement to end in 2006 but early retirement might not be reduced appreciably in the mean time
AT	Improve pension contributions-benefits link and improve older worker participation.	Statutory retirement age is gradually raised, extension of the period over which individual benefit entitlements are calculated.	Provisions of the 2004 draft law constitute a step backwards , *inter alia* due to facilitation of early retirement.
PL	Lower the tax burden on labour, reform the tax-benefit system to eliminate financial disincentives to work, and to increase the efficiency of social spending..		Steps to limit early retirement, new rules for sickness benefits and family allowances.
SL	Review the tax-benefit system with a focus on participation of older workers.	Tax exemptions and subsidies to encourage employment of older workers.	
FI	Improve tax-benefit incentives and eligibility criteria, particularly for older workers.	Income tax cuts.	
SK	Lower the very high combined health and social contribution rates, while observing the overall budgetary consolidation constraints.	Benefits introduced to increase work incentives for successful job seekers; reduction of employer contribution rate.	
SE	Pursue reforms of tax and benefit system to improve work incentives.		Labour income tax cuts and stricter enforcement rules for sickness insurance. Increase in social benefit levels and extension of "free-year" initiative.
UK	Improve work incentives, particularly by reforming sickness and disability benefits.	Extension of pilot schemes for support of disabled workers' integration into the labour market.	Reform of policies after assessment of pilot schemes.

Box 2: Follow up to country specific recommendations related to labour markets (continued)			
Country specific recommendation (as an extension of general Guidelines no. 4-8)		**Significant Reform Measures in 2004**	
		Adopted	**Proposed**
GUIDELINE 5: Ensure that wage bargaining systems allow wages to reflect productivity, taking into account productivity differences across skills and local labour market conditions			
DE	Reform wages to reflect productivity differences through reviewing Günstigkeitsprinzip.	Relaxation of favourability principle under consideration.	
EE	Ensure that wage developments, including changes to minimum wage legislation, do not hinder employment growth.		
EL	Reform wage bargaining to reflect productivity differences.	Increase in minimum wage above expected inflation and productivity.	
ES	Reform wage setting to reflect productivity differences and phase-out indexation provisions in collective agreements.		
IE	Social Partners to allow wages to adapt to productivity and skills differences.	Fairly moderate pay provisions agreed, increasing use of benchmarking in setting wages for public sector.	
IT	Encourage more decentralised wage setting to better reflect productivity and skills.		
HU	Encourage wage-setting (including multi-annual agreements with social partners) which allows wages to better reflect productivity and promotes low inflation.	Freezing of minimum wages and public sector wage moderation.	
PL	Increase the flexibility of wage-setting to ensure wages better reflect productivity differences.		
PT	Encourage wage moderation to allow increases to take into account productivity and skills.		Social pact on pay moderation and collective agreements
FI	Reform wage bargaining to reflect productivity differences.		
SL	Liberalise administered prices and advance further with de-indexation, in particular with the wage setting mechanism.		
SK	Allow more flexibility in the wage setting mechanism.		

Box 2: Follow up to country specific recommendations related to labour markets (continued)			
Country specific recommendation (as an extension of general Guidelines no. 4-8)		**Significant Reform Measures in 2004**	
		Adopted	**Proposed**
GUIDELINE 6: *While respecting the role of social partners according to national practices, review labour market regulations notably by relaxing overly restrictive employment protection legislation (EPL) and addressing those relating to employment contracts, and promote more adaptable and innovative work organisation.*			
DE	Further reduce regulatory and administrative burden, i.a. by lowering effective degree of employment protection.	Maximum duration of temporary contracts raised; higher threshold to apply provisions on protection against dismissal.	
EL	Improve flexibility & security balance; modernise work organisation; review labour market regulations.	PES upgraded; creation of Job centres and a centralised information system; measures to extend part-time employment.	
ES	Further reform EPL to reduce labour market segmentation across types of contract.	New social accords to modernise the public administration.	
IT	Further reform EPL and reduce labour market segmentation across different contract types and firm size.	Increased variety of labour contract, which may heighten labour market segmentation; employment service sector is opened and liberalised to private firms.	
SL	Address the imbalance between temporary and permanent work conditions.		
GUIDELINE 7: Facilitate labour mobility, both geographical (within as well as across countries) and occupational, especially by promoting the recognition of qualifications and the transfer of social security and pension rights, by eliminating obstacles to mobility related to the housing market, and by promoting lifelong learning.			
CZ	Enhance occupational and regional mobility by deregulating the housing market and improving transport infrastructure.		
EE	Promote vocational training and lifelong learning		Vocational education development plan for 2005-08
ES	Continue to facilitate geographical mobility, i.a. remove fiscal distortions and improve rental market conditions and availability of land for development.	Measures to ease housing search and change of residence; 2002-2005 housing plan continues to be implemented.	
LV	Facilitate labour mobility by improvements in transport infrastructure.		
LT	Enhance regional mobility.	Improved transport infrastructure and quality of public transport.	
HU	Remove obstacles to regional mobility through appropriate housing and transportation policy.	Tightening of the housing loan scheme.	Eligibility for new house purchases somewhat broadened.
PL	Remove obstacles to regional mobility, especially through reform of the housing market and improvements in transport infrastructure.	Mobility grants for certain groups of persons.	Improve the regional passenger transport network.
SL	Reassess lifelong learning activities.		
SK	Remove obstacles to regional mobility and reduce skill mismatches, whilst ensuring the efficiency of retraining measures..	Financial support for commuters; continued improvements in the transport infrastructure including public transport; housing benefits and measures.	
GUIDELINE 8: Ensure efficient active labour market policies (ALMPs) with special attention to people facing the greatest difficulties in the labour market, according to rigorous impact evaluations.			
DE	Continue to improve efficiency of ALMPs, in particular job search assistance. Improve cost-effectiveness and targeting.	End of ALMPs leading to requalification to unemployment benefits	Design of individual plans mandatory
EE	Adopt policies with particular emphasis on re-integrating the long-term unemployed.		
LT	Ensure the efficiency of education, retraining and other ALMPs.	Promotion of vocational training.	
HU	Encourage disadvantaged groups to enter the labour market.	Grant scheme to promote (re-)integration of women into the labour market; medium-term action plan initiated to promote education and training of the Roma minority.	
MT	Strengthen retraining, particularly in relation to labour shedding and returning middle-age women to work.	Increased opportunities for lifelong learning.	Improvement of provision of grants to firms that train their workers.
SK	Ensure the efficiency of retraining measures and other ALMPs.	Ongoing reform of the education system.	Evaluation methodology for ALMPs under preparation..

Box 3: Follow up to country specific recommendations related to product markets			
Country Specific Recommendations (as an extension of general Guideline no. 9)		**Significant Reform Measures in 2004**	
		Adopted	**Proposed**
GUIDELINE 9: Foster competition in goods and services markets.			
BE	Enhance effective competition in network industries and in local services.	Transposition of EU directives in telecommunications, energy, postal services and railways.	
DK	Enforce competition in sectors where it is inadequate.	Competition Act was updated to bring it into line with the modernisation of EU competition law.	Recommendations made to increase competition in some sectors (legal profession, housing sector, and taxi services) where it is ineffective.
DE	Create a more competitive environment.	Lifting of existing ban on special sales in the retail sector; partial liberalisation of entry into handicraft trades.	Alignment of German competition law with EU legislation on 1 January 2005; creation of a regulator and unbundling in energy sector.
EE	Liberalise electricity market, strengthen independence of regulator and ensure competition in telecoms.	Introduction of number portability in fixed telecommunications.	Legal unbundling of the transport system operator in energy; connecting the electricity network with the Finnish one.
EL	Enhance competition in the energy sectors.	Licences to independent power generators were granted in 2004; amendments to the legislation to fully transpose the EU energy directives.	Expected interconnection between the Greek and Turkish gas networks.
ES	Enforce effective competition in retailing and monitor developments on the electricity market.	Draft law approved encouraging higher flexibility for shops opening hours across all Spanish regions.	The creation of the Iberian integrated electricity market is set for the 30th June 2005; preparation of a white paper on the reforms of the competition framework..
FR	Ensure competition in energy markets. Raise the transposition rate of Internal Market directives and reduce number of infringements.	Liberalisation of the gas and electricity markets for non households users; law to allow the government to accelerate the transposition of directives; decree to organize the follow up of the transposition at the ministerial level.	
IE	Increase competition in network industries and certain other sectors.	In postal services outbound cross border mail services fully opened to competition; liberalisation of electricity supply for all large customers and many SMEs; liberalisation of gas supply for all non-household customers.	Legislative proposals to remove a limited number of restrictions on pharmacies and to liberalise liquor licensing; a competition report on the auctioneering and estate agency professions is expected in early 2005.
IT	Increase effective competition in the service sector, widen the opening of the energy markets, and improve the implementation of Internal Market directives.	Creation of the Electricity power exchange, Marzano Law and Decree of May 2004 on the transmission network.	Ongoing discussion at the Parliament on proposals to increase competition in the professional services sector.
LU	Fully implement the reforms of the competition law and ensure that competition and regulatory authorities have sufficient independence, resources and power.	The modernisation of the legislative framework for competition policy was finalised.	
LV	Enhance effective competition in network industries and strengthen role of the regulator; increase physical interconnections with other European networks.		Draft law to transpose EU energy directives; move to one-tier state-level regulation instead of the current two-tier state- and local-level system; creation of a modern and high-speed interconnection between the Baltic States and Poland; creation of a common Baltic electricity market and projects to connect the electricity network with those of Poland and Finland.
LT	Increase liberalisation and competition in energy, telecoms and railway markets; improve interconnection capacities with neighbouring EU Member States.	Transposition of EU energy directives; number portability and digitalisation of fixed telecommunications lines; unbundling in railways sector.	Creation of a modern and high-speed interconnection between the Baltic States and Poland; creation of a common Baltic electricity market and projects to connect the electricity network with those of Poland and Finland.

Box 3: Follow up to country specific recommendations related to product markets			
Country Specific Recommendations (as an extension of general Guideline no. 9)		**Significant Reform Measures in 2004**	
		Adopted	**Proposed**
GUIDELINE 9: Foster competition in goods and services markets.			
HU	Proceed with liberalisation of the network industries, increase effectiveness of competition and the independence of the network regulators.	Liberalisation of the gas and electricity markets for non households users; reduction of sunk costs relating to long term contracts agreements; Act on electronic communication has entered into force; Postal Act has entered into force.	
MT	Increase competition in certain sectors, including network industries, food industries and shipbuilding.	Continuation of privatisation programme (Sea Malta); regulations for the licensing of activities in the electricity sector and relating to electricity tariffs; dismantling of levies on agriculture and agro-food products finalised by Malta's accession to the EU.	Announced privatisation for a number of state-owned holdings (Bank of Valletta and Maltacom).
NL	Improve the regulatory framework as well as its implementation.	Strengthening of the Dutch Competition Authority (NMa) and concentration of its action on the sector featuring weak competition.	
AT	Increase resources of the competition authority and enforce decisions of the telecoms regulator.	Slight increase in the number of competition authority staff.	
PL	Reduce overall states aids and reorient towards horizontal objectives; encourage market entry and competition in network industries while pursuing a greater connectivity of national markets.	Application of the EU regulation for telecommunication (Telecommunication law stimulating competition).	Announced privatization in the energy sector in 2005.
PT	Enhance effective competition in liberalised utilities and increase the transposition rate of Internal Market directives.	Liberalisation of fuel prices; eligibility to freely choose the electricity supplier has been extended to all consumers.	The creation of the Iberian electricity market was announced for the 30th June 2005.
SL	Improve competition through strengthening administrative capacity of the Competition Protection Office, easier entry in network industries and facilitating the purchase of lands for industrial use.	Amendments to the Energy Act, allowing non-household users to choose their electricity supplier; use EU structural fund subsidies for renovation of public and utility infrastructure aimed at increasing the supply of land for industrial use.	Plans to increase staff to at least 37 but no clear timescale; New Act will confer direct responsibility for issuing fines on Competition Authority.
FI	Enforce competition in network industries and non-tradable services.	Harmonisation of Finnish competition law with the modernised EU competition law; set up of a Competition Institute.	Implementation of the EC directive on the regulation of access to communications networks into Finnish legislation.
SE	Enforce competition in sectors where it is inadequate.	A law is expected to increase price transparency for all goods, services, and utilities marketed to consumers; some suspected cartels in the construction sector are currently being investigated by the competition authorities.	Project to increase competition and trade in the construction sector involving the Nordic and Baltic countries and Poland; investigation in order to improve the implementation of competition policy; a commission will present measures on how to increase competition in the foodstuffs and construction sectors.
UK	Improve competition in sectors like the professions, postal services and pharmacies.		The government is considering reform of the regulatory framework for legal services; further investigation into the matter of public sector procurement in a number of sectors; full liberalisation of postal services, by abolishing all restrictions on market entry, by January 2006.

Box 4: Follow up to country specific recommendations related to product markets and knowledge based economy			
Country Specific Recommendations (as an extension of general Guidelines no. 11, 13 and 14)		**Significant Reform Measures in 2004**	
		Adopted	**Proposed**
GUIDELINE 11: Generate a supportive environment for entrepreneurship and for SMEs to start-up and grow.			
CZ	Remove administrative burdens, improve and enforce the legal framework and increase access to finance.	Merger of agencies for support of businesses to better integrate EU funds.	New bankruptcy legislation. Better operation of the Commercial Register.; One-stop-shops for businesses.
BE	Improve public administration and pursue the reduction of administrative burden for companies.	Follow-up of the Copernicus reform. “Kafka Plan” to cut red tape; implementation of the single database for company data.	
DE	Reduce the regulatory and administrative burden.	14 out of 74 projects foreseen have been implemented; two new venture capital funds for high-tech start-ups.	
EL	Simplify the business and taxation environment and raise the transposition rate of Internal Market directives.	New legislation to reduce bureaucratic and legal obstacles to setting up a new company; measures to increase the efficiency of the public administration, tax reform.	
ES	Reduce the administrative burden on business.	Opening of more one-stop shops; extended availability of firm-support online facilities; changes to the accounting regime for SMEs to simplify compliance with tax and accounting obligations; new insolvency law.	
FR	Reduce and simplify business regulations.	Measures have entered into force (following the 2003 economic initiative law) to stimulate business creation. and to simplify business regulation and administrative burdens; development of E-government; Innovation Plan.	Law to further develop and reduce obstacles to entrepreneurship; tax reforms.
IT	Reduce the administrative burden on business.	Simplification law voted in 2003; automatic cancellation from the register of closing businesses.	
CY	Continue to simplify the business and taxation environment.	Implementation of e-government services; a scheme to support youth entrepreneurship in the manufacturing sector, and e-commerce as well as activities related to services in tourism; compliance with the VAT rate.	
LV	Encourage an entrepreneurial culture.	Guidelines to promote entrepreneurship; decrease of corporate tax rate to 15%.; state-guaranteed loans.	
LU	Encourage the creation of SMEs and help those to access venture capital.	A risk capital enterprise was launched to foster access to venture capital; action plan “Entrepreneurship au Luxembourg Entreprendre pour réussir”.	Generalisation of audits of the effects of new legislation and regulation on the business environment, with particular emphasis on SMEs.
HU	Ensure stability of legislation and Government policies to create a business environment more supportive to entrepreneurship.	Act on electronic business registration; amendment to the act on bankruptcy procedures; the simplified business tax system has been extended to more businesses; reduction in corporate income tax rate; extension of the four stage credit programme.	
PL	Reduce administrative burdens, simplify regulations and improve access to finance.	Law on Freedom of Economic activity; amendment of the law on the National Criminal Register.	Creation of the one-stop-shop for business registration in 2007.
SL	Reduce time and costs to set up a new business and simplify administrative procedures affecting business.	Passed two new Acts designed to increase support for small businesses and simplify licensing rules; information and business support elements of the one-stop-shop system implemented.	Implementation started on third element of one-stop-shop system, to allow registration of a business in 14 days; other regulatory decrees to eliminate unnecessary administrative barriers for small businesses being drafted.
SK	Strengthen legislative framework, particularly through adopting new bankruptcy legislation and improving the judicial system.	Improved operation of the Commercial Register and Estates Register; reduction in the corporate income tax rate and simplification of the tax system.; an institute of court administrators responsible for acts of an administrative nature has been introduced to speed up the court proceedings; new bankruptcy legislation.	On-line communication with the Commercial Register, unified forms, one-stop-shops for entrepreneurs, on-line submission of tax declarations, and better transmission of information within the administration.

Box 4: Follow up to country specific recommendations related to product markets and knowledge based economy (continued)			
Country Specific Recommendations (as an extension of general Guidelines no. 11, 13 and 14)		**Significant Reform Measures in 2004**	
		Adopted	**Proposed**
GUIDELINE 13: Take active steps to promote investment in knowledge, new technologies and innovation and make progress towards the 3% of GDP objective of total R&D investment.			
CZ	Improve the education and training system and its responsiveness to changing skill requirements; improve R&D and innovation activities knowledge transfer through R&D and support knowledge diffusion.	Reform of elementary and secondary schooling was adopted; investment incentives for strategic services and technological centres introduced; tax deductibility of R&D expenditures.	Reform of tertiary education.
DE	Reform education and training system.	National agreement to increase number of training places on offer over the next 3 years; update of occupational profiles for vocational training; € 4 billion federal grant to create all-day schools.	Creation of assistant professorships without 'Habilitation'.
EE	Improve the education system and vocational training (including life long learning); implement the 2001 R&D strategy including promoting involvement of business sector in R&D spending.	Estonian National Development Plan 2004-2006.	Vocational education development plan for 2005-2008.
EL	Increase the availability of skilled human capital, promote business involvement in R&D and innovation, and improve ICT diffusion.	Actions promoting the development of information technology in schooling and professional training; actions to promote the use of ICT within business communities ("Go electronically" and "e-business development") and by the public sector.; links between universities and enterprises further strengthened through initiatives supporting the establishment of spin-off-firms.	
ES	Increase skilled human capital, investments in R&D and innovation, and ICT diffusion.	Measures taken to develop further the National System of Qualifications and Vocational Training; the 2004-07 National R&D+I Plan.; additional initiatives to foster e-government.	Changes announced to the legislative framework of the education sector.
IE	Prioritise roll-out of infrastructure and raise the level of R&D.	Completion of a number of broadband projects and road by-passes; introduction of a 20% tax credit for incremental R&D expenditure announced in the 2004 budget.	Euro 5bn investment programme for 2004-2006 in new water and sewerage infrastructure announced in May 2004.
IT	Raise the education and skill base of the population; increase investment in R&D and innovation; promote ICT take up, in particular through measures targeted at SMEs.	Reform of the school system and universities; creation of the Italian Institute of Technology; R&D support through tax incentives.	
CY	Increase skilled human capital, promote R&D and innovation, and improve conditions to facilitate ICT diffusion.	Measures towards the development of information technology in schooling; a scheme to promote innovative projects and the adoption of new technologies.	Preparation of a national strategy for the development of information society (including e-Government services and e-commerce).
LV	Improve education and training systems and their responsiveness to labour markets' needs; encourage R&D and innovation, particularly in the business sector.	Multi-annual plan for education; national innovation programme to promote R&D and innovation.	
LT	Improve education and training systems and their responsiveness to market needs; promote R&D and innovation; strengthen business-research institute links and support knowledge transfer through FDI and higher IT penetration.	Lifelong learning strategy for vocational training; financial actions to promote R&D, IT and innovation.	
HU	Promote involvement of private sector in R&D and innovation; strengthen business-research institute links; ensure resources to improve research quality and support knowledge transfer through FDI; improve education and vocational training systems to better enable them to adapt to skill needs of the market.	Modernisation of the regulation on vocational training; grants to educational institutions through the National Higher Education Strategy to encourage research and educational attainment; increase in support for adult education; launch of the national research and technology office; launch of the research and technological innovation fund; launch of a scheme to strengthen the link between research and businesses; bill on research and development and technical development.	Reform of the system of secondary school leaving examination.
MT	Improve the quality of secondary education and vocational training.		Plans to review and improve the provisions of the Business Promotion Act.

Box 4: Follow up to country specific recommendations related to product markets and knowledge based economy (continued)			
Country Specific Recommendations (as an extension of general Guidelines no. 11, 13 and 14)		**Significant Reform Measures in 2004**	
		Adopted	**Proposed**
GUIDELINE 13: Take active steps to promote investment in knowledge, new technologies and innovation and make progress towards the 3% of GDP objective of total R&D investment.			
NL	Promote technology oriented education and strengthen science-industry links.	Techno Partner Action Programme to stimulate the university-industry links; programmes aimed at increasing the number of science and technology students and boosting entrepreneurial potential.	
AT	Encourage business research and innovation, especially for SMEs.	Creation of the Austrian Research Promotion Company; reform of the fund providing resources for scientific research (FWF) in order to modernise the organisational structure and increase transparency; creation of the national foundation for research and development.	
PL	Improve the education and training system and its responsiveness to changing skill requirements; promote R&D and innovation, in particular in the business sector, and support knowledge transfer through FDI.	Law of 20April 2004 promoting investment in training and lifelong learning; general education reform to develop entrepreneurial potential; ePoland (strategy for 2004-2006); pilot programme for knowledge transfer through IT for SMEs.; targeted projects towards implementation of R&D results in the economy.	
PT	Promote stronger involvement of the business sector in R&D, innovation and ICT; improve the efficiency of spending in education.	Citizen's portal launched to provide electronic access to various public services; transposition into national law of EU directive on electronic commerce; legislative reforms implemented to regulate the use of electronic documents; reforms to the education system have continued to modernise curricula, promote the use of IT and vocational education; new Plan for the Prevention of School Drop-out introduced to cut early school leaving by half by 2010.	A new Science and Innovation Action Plan is due to be implemented soon; a new Vocational Training Bill was proposed by the Council of Ministers.
SL	Promote R&D and innovation in the business sector and improve tertiary education.	Tax incentives for companies investing in equipment for R&D; substantial tax relief to companies who hire PhD graduates; new laws adopted on higher education and post-secondary education (Bologna and Brugge-Copenhagen processes).	Decision to finance the establishment of eight to nine centres of excellence, co-financed by European structural funds.
SK	Improve the education and training system and its responsiveness to changing skills requirements; encourage R&D and innovation and knowledge transfer through FDI.	Reform of elementary and secondary education.	Reform of tertiary education introducing the tuition fees.
UK	Monitor closely existing measures to promote R&D; review and strengthen policies aimed at improving basic skills in the workforce.	Some steps taken to monitor Science and Innovation Investment Framework; increased take up of the employer training pilots' scheme; reform of the apprenticeship schemes including young apprenticeships for 14-16 year olds	Plans to introduce trials of apprenticeship programmes for adults.
GUIDELINE 14: Enhance the contribution of the public sector to growth.			
DK	Increase the efficiency of the public sector.	Investigation into the modernisation of public sector roles and where possible delegation to private sector; requirement to test all public sector building and construction projects for their appropriateness as public-private partnerships.	Decision to completely overhaul municipal system of government by 2007 to improve efficiency; transfer to central government of responsibility for tax collection and recovery of debts owed to public authorities.
FI	Increase the efficiency of the public sector.	Further implementation of the 2003 action plan on improving efficiency of public sector both at national and municipal levels; advisory board founded to increase understanding and use of public procurement.	Legislative reform aimed at improving competition in public procurement is currently being drafted.
SE	Increase the efficiency of the public sector.		Project on the terms of implementation of the EC directives on public procurement in Swedish law; report of the Council for Municipal Analysis on the development of indicators for public sector efficiency assessment.

Box 5: Follow up to country specific recommendations related to pension systems			
	Country specific recommendation (as an extension of general GL no 16)	**Measures**	
		Adopted	**Proposed**
GUIDELINE 16: Design, introduce and effectively implement reforms of pension systems			
CZ	Reform pension system.		
BE	Reinforce measures to postpone retirement from the labour force.		
DE	Promote supplementary pension schemes, strengthen incentives for later retirement.	Gradual introduction of taxation for pension benefits, coupled with tax exemptions for retirement contributions; indexation formula linking benefits to the system dependency ratio; support for financial products eligible for subsidised fully funded supplementary private pension income through trimming of red tape; early retirement for previously unemployed and those previously in a gradual retirement schemes (Altersteilzeit) postponed from 60 to 63 years as of 2006.	
EL	Pursue reforms of the social security system, and in particular the pension system.	Incentives provided for the prolongation of working life beyond the statutory limit of 35 years; mobility of social security rights between funds; amendments of the legislation related to the persons with disabilities, farmers, professionals and civil servants.	
ES	Strengthen link between contributions and benefits and control the long-term increases in pension expenditure.	Setting up of a pension fund to complement civil servants' pensions; further endowments to the Pension Reserve Fund amounting to € 9 bn in the course of 2004	Further endowment to the Pension Reserve Fund of € 5.3 bn (0.6% of GDP) in 2005 to reach € 24.2 bn (2.9% of GDP).
FR	Undertake comprehensive reform of the pension system		
IT	Address long transition period to the new contributions-based system and promote supplementary privately funded pension schemes.	Tightening of the eligibility criteria to qualify for a seniority pension after 2008; privately funded schemes promoted by enabling employees to divert the annual flow of funds currently accounted by employers as *trattamento di fine rapporto* - the implementation of this measure requires secondary legislation, which is expected to be adopted in 2005.	
AT	Reform public pension system; increase low average effective retirement age and ensure incentives to work are enhanced.		New regulation regarding harmonised pension system refers only to persons becoming civil servants after the law enters into force. Possibility for early retirement at 62 years of age for employees made redundant and workers having done heavy-duty manual labour. Formula for annual adjustment of pension levels without automatic adjustment for demographic change.
PL	Monitor implementation of pension reform.		
PT	Adopt further reforms to the pension system for workers in the general government.		
SK	Greater effort to ensure effective and functioning implementation of the new pension system	Ongoing measures and introduction of a sizeable funded pension pillar.	