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Annex to the

Second Implementation Report on the

2003-2005 Broad Economic Policy Guidelines

- Part II Country notes-

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1. BELGIUM

Introduction

After a prolonged slowdown in economic activity between mid-2000 and mid-2003, real GDP growth picked up in the second half of 2003. GDP is likely to have risen by 2.5 per cent in 2004. For 2005, similar growth figures are expected. The Belgian government debt remains one of the highest among the EU states (95.8 per cent of GDP in 2004), although it has been falling steadily since 1993. Unemployment is a second major economic challenge for Belgium also in view of the sustainability of public finances ahead of the ageing impact on pensions. Employment started to pick up again in 2004 with 0.4 per cent growth and further growth is expected in 2005. The low activity rate remains an important structural weakness of the Belgian labour market (66.9 per cent in 2004, compared to 72.1 per cent for EU-25), particularly for older workers. The government has taken some measures to improve incentives to work in 2004. However, after the adoption of some measures in 2002 and 2003, progress in preventing early retirement remained limited in 2004. Belgium has a high level of hourly labour productivity. Competition from abroad allows Belgium to sustain below-average price levels. A serious effort is made to increase R&D expenditure and to enhance the innovative capacity of the economy through education and training in light of a long-term deficit of skilled R&D personnel. In network industries, the transposition of European legislation could ease the high Belgian prices. Continued efforts are being made to improve the business environment but the reform of the public administration has been pursued more modestly. A detailed assessment of recent developments in addressing Belgium's key policy challenges is presented in the following sections.

1. Long-term sustainability of public finances

Ensure the continuation of the budgetary adjustment in the forthcoming years, in particular in view of ensuring the long-term sustainability of public finances in the face of population ageing	Assessment
Under this challenge, Belgium was requested to:	
1. ensure that the government debt ratio is kept on a sustained declining trend at a satisfactory pace by maintaining high primary surpluses (GL 15);	In progress
2. limit the real expenditure increase in Entity I (federal government and social security) to 1.5 per cent and allocate proceeds stemming from higher than expected economic growth to improve the budgetary position as a matter of priority; and	Limited
3. strengthen the existing strategy in order to prepare for the budgetary implications of population ageing: in particular by reducing the debt level, better addressing the low effective retirement age, pursuing the reform of the pension systems, and strengthening efforts to finance the ageing fund (GL 16 and E-REC 2).	In progress
Bearing in mind the three-year period available for implementation, the degree of implementation since 2003 is indicated as: "Complete" for (practically) complete; "In progress" where progress is well advanced; "Limited" where the recommendation is only partially addressed and "Insufficient" where no substantial measures going in the right direction have been taken.	

The debt ratio stays on a downward path but primary surpluses diminish and the decline in interest payments slows down

In 2004 Belgium posted a slight deficit in its general government accounts (0.1 per cent of GDP). This was the 5th consecutive year with the government accounts in slight surplus or close to balance, whereas the debt fell below 100 per cent of GDP for the first time since the early eighties (95.8 per cent of GDP in 2004). This was achieved despite lower one-off positive measures than in 2003 (0.6 per cent of GDP compared to 1.5 per cent in 2003) partly owing to higher than expected real GDP growth. Indeed, the economic recovery contributed to higher increases in direct and indirect taxes than in the previous years. Lower interest payments contributed to improving the government accounts, but a strong overrun in health care pushed up primary expenditure in 2004 and appears as a major problem also for the years ahead.

The primary balance has been decreasing over the last few years (from 7.2 per cent of GDP in 2001 to 4.8 per cent in 2004) and is forecast to fall further to 4.2 per cent of GDP in 2005. The cyclically-adjusted primary surplus decreased from 6.5 per cent of GDP in 2002 to 5.3 per cent in 2004 and is forecast to decrease to 4.5 per cent in 2005. The debt ratio fell further in 2004, from 100 per cent in 2003 to 95.8 per cent in 2004, a level which had not been reached since the early eighties. Interest payments fell further to 5.0 per cent of GDP in 2004. All in all Belgium needs to maintain primary surpluses high.

Continued overrun in health expenditures is a serious problem

The government has been relatively successful in controlling public expenditure with one important exception: health care spending. In the 2004 budget expenditures have been allowed to increase only in a few areas, including health, justice and investment. Given past overruns, the government decided to set new and higher targets on health care spending of 4.5 per cent in real terms. This turned out to be hardly compatible with the recommendation to limit the yearly real increase expenditure of Entity I (the federal government and social security) to 1.5 per cent. Correcting for the one-off transfer in subsidies for the railway company SNCB from 2004 to 2003, Entity I expenditure rose above 3 per cent in real terms. This is mainly the result of a substantial overrun in health care spending, which is estimated to have increased by around 6 per cent in 2004 (compared to the target of no more than 4.5 per cent). Further measures are clearly needed to curb real expenditure in this area. As to proceeds stemming from higher economic growth in 2004, the government respected recommendation 2 as the cyclically-adjusted budgetary surplus (after correcting for the impact of one-off measures) barely changed from 2003 to 2004.

Budgetary implications of population ageing: government accounts in the right direction but with some qualifications

In view of population ageing, the challenges for Belgium are twofold. First, there is the issue of sustainability of public finances. Second, there is the issue of increasing the activity rate and the employment rate, which will be addressed in the next section. As regards the public finances, the debt-to-GDP ratio has been falling steadily as mentioned above and should continue to go further down. The slightly worrying development is that the primary surplus, although still at 4.8 per cent of GDP in 2004, has been on a steady downward path. As to reforming the pension system, the authorities have taken a number of measures in 2003 such as the increase of the number of participants within the second pillar in the pension system (see the 2004 BEPG Implementation Report). The extension of a complete working career for women from 40 to 45 years corresponds to the finalisation of the progressive implementation of the 1997 reform. Against this background no further steps were considered necessary.

With a view to meeting the challenges of population ageing, the Belgian authorities have followed a two way approach of reducing the debt and building an ageing fund using budget surpluses and non-recurring receipts. This fund is meant to be used in the period 2010-2030. By the end of 2004, the ageing fund accumulated assets worth EUR 11.9 billion (4.2 per cent of GDP). However in 2003 and 2004 a substantial part of the non-recurring receipts came from the taking over by the government of the Belgacom pension fund (EUR 1.4 billion), which improved the government accounts but also had a counterpart effect of increasing government pension liabilities. The authorities justified the recourse to these one-off or temporary measures with the need to keep the debt-to-GDP ratio on a downward trend at a time of slow economic growth. However focusing only on the positive side of those transactions gives a biased view of their long-term impact. Now that the cyclical developments are roughly neutral (GDP growth near potential) the government should refrain from using further one-off measures, which actually seems to be the case.

2. Labour market and regional development

Increase the low participation and employment rates, especially for older workers and women, and improve incentives to work	Assessment
Under this challenge, Belgium was requested to:	
4. take further steps to reinforce measures to postpone retirement from the labour force, in particular by combining a removal of incentives to early retirement (GL 16) with enhanced prevention and activation measures for older workers; and	Limited
5. continue progress in making work pay by eliminating the major distortions to work incentives arising from the interaction of the tax and benefit systems (GL 4).	In progress

Measures to postpone early retirement taken in the last few years are gradually implemented, but further progress remains limited.

A low employment rate especially among older workers (26.7 per cent compared to an EU-average of 40.1 per cent for the age group 55-64) is a major structural problem of the Belgian labour market. Some limited measures were approved in 2002 and 2003 to stimulate employment in the age category above 50, including: taxing complementary pensions and raising the age until which older unemployed people have to search for a job (stepwise to 56 years in 2002, 57 in 2003, and 58 years as from 2004), reducing social security contributions for older workers (started to be applied in 2004), applying financial stimuli for older workers who remain part-time employed and promoting a reduction of working hours for that same category of workers carrying out physically demanding work. These measures have been adopted in agreement with employers and the trade unions.

In 2004 no new measures were adopted but tripartite negotiations have taken place to prepare agreements with the social partners to limit the access to the system of early retirement and extend further the effective working years. The government aims to carry out all these measures on the basis of social agreements. The authorities do not intend to change the legal retirement age while there is consensus on giving priority to early retirement of workers with long careers or subject to hard physical work, instead of e.g. workers in restructuring companies. All in all, although there is a slow process towards removing incentives to early retirement, so far little progress was registered in increasing activity and employment rates, which have remained broadly unchanged in 2004 and remain among the lowest of the EU.

On top of ongoing implementations of tax reform, some further measures have been taken to make work pay.

The ongoing direct tax reform (approved in 2001 for progressive implementation until 2006) reduced the tax burden on labour by 0.2 per cent in 2004. After full implementation the tax reform should result in a total tax alleviation of 1.6 per cent of GDP by 2007. Lower social security contributions (decided in 2003 and progressively implemented until 2005) further reduced the tax burden on labour by some 0.1 per cent of GDP in 2004. In addition, in 2004 the government decided to introduce a 'work bonus' (for progressive implementation in 2005-2007) which is an increased rebate of social security contributions for low-income workers. The objective of the work bonus system is to stimulate employment by lowering labour costs, to make employment more attractive for low-income workers and to avoid 'unemployment traps'. Moreover, measures have also been implemented in 2004 to quickly reactivate newly unemployed after company restructuring. These measures include the sponsoring of employment cells responsible for out-placing laid-off workers and temporary reductions in social security contributions for companies rehiring unemployed.

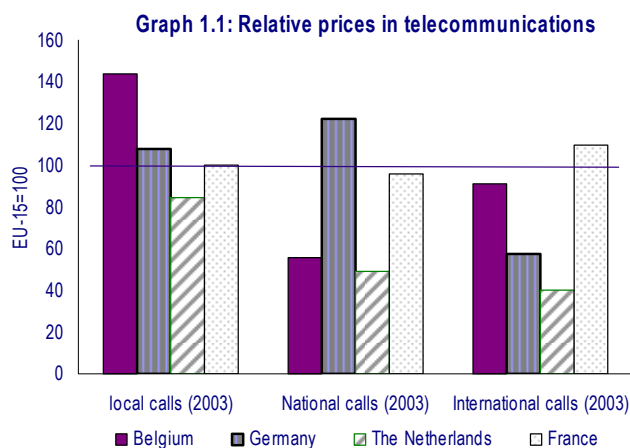
Employment has been promoted through the implementation of a revised system of service vouchers decided at the end of 2003. In this system the government sponsors officially registered workers in certain household services which otherwise are often performed through the informal economy. Although the government's funding of these services has been reduced in the 2005 budget, the authorities maintain its initial target of creating 25000 part-time jobs by 2007. Finally, measures have been taken to gradually step up controls on the availability of the unemployed for accepting a job offer, particularly as regards the long-term unemployed receiving unemployment benefits.

3. Productivity and business dynamism

Enhance competition in certain services sectors and continue to increase the efficiency of the public administration and to improve the business environment	Assessment
Under this challenge, Belgium was requested to:	
6. take measures to enhance effective competition in network industries and in local services (in line with GL9); and	Limited
7. improve public administration in the context of the ongoing reform and pursue the reduction of administrative burden for companies (GL11).	In progress

Transposition of EU legislation is slowly enhancing effective competition in network industries...

Liberalisation of network industries is progressing through the transposition of the EU legislation. In telecommunications, a draft law to transpose the EU package will enhance the powers of the regulator and will introduce a tendering procedure for the provision of universal service obligations. Although favourable developments have been registered in the number of unbundled lines and in the penetration of mobile and broadband



communications, prices in the fixed lines segment have had a tendency to increase and prices for local calls remain amongst the highest in the EU. The full liberalisation of energy supply in Flanders in 2003 and the compliance with EU directives concerning market opening for non-household users in Brussels and Wallonia have increased the number of active players and led to price reductions, renegotiations of contracts and consumers' switching in the competitive segment. Globally 90 per cent of each - electricity and gas - market is opened to competition. Legislation in postal services and railways is being brought into conformity with EU legislation. However, no specific concrete action has been taken to enhance effective competition in other local services.

...and good efforts have been delivered to cut the administrative burden for businesses.

The *Copernicus* reform to improve federal public administrations has been pursued under new labels although more modestly. Most reforms concern additional training possibilities and measures to improve the service to the public. The implementation of a new performance-based remuneration system has been completed for all civil servants. Good efforts have been made to reduce the administrative burden with a focus on the reduction of administrative barriers for new businesses. The estimated burden stood at around 3.4 per cent of GDP in 2002, virtually unchanged compared to 2000, with a disproportionate weight on SMEs. To decrease this burden, 61 projects out of the 100 contained in the "Kafka Plan" to cut red tape are expected to be implemented by the end of 2004. The number of days needed to set-up a new business has been dramatically cut from an average of 56 to 11. The long-term objective is a smooth three-day procedure for setting up new businesses. The final implementation of the single database for company data will make contacts between companies and administrations easier. In the context of a federal State, the reduction of administrative burden at the regional level is very important. Initiatives to measure benchmark and reduce the administrative burden, to carry out impact assessments of new legislation and to introduce one-stop-shops have been implemented to various degrees in the three regions.

Table 1.1: Economic indicators for Belgium

	Belgium				EU-25			
	2001	2002	2003	2004	2001	2002	2003	2004
General economic background								
Real GDP growth ¹	0.7	0.9	1.3	2.5	1.8	1.1	1.0	2.5
Inflation ²	2.4	1.6	1.5	2.0	2.5	2.1	1.9	2.2
Labour productivity growth ³	-0.7	1.2	1.2	2.1	0.8	0.9	0.9	2.1
Employment growth ¹	1.5	-0.3	0.0	0.4	1.0	0.3	0.3	0.4
Nominal wage growth ⁴	3.6	3.7	2.5	2.7	4.0	3.2	3.1	3.0
Current account ⁵	4.5	5.8	4.4	4.5	:	:	:	:
Unemployment ⁶	6.7	7.3	8.0	8.2	8.5	8.9	9.1	9.1
Public finance								
General government balance ⁵	0.6	0.1	0.4	-0.1	-1.2	-2.3	-2.8	-2.8
Primary balance ⁵	7.2	6.1	5.7	4.8	2.4	1.0	0.3	0.2
Cyclically-adjusted balance ⁵	0.2	0.6	1.1	0.4	:	:	:	:
Gross government debt ⁵	108	105.4	100.0	95.8	62.1	61.6	63.2	63.5
Employment								
Employment rate ⁷	59.9	59.9	59.6	:	62.8	62.9	63.0	:
Female employment rate ⁸	51.0	51.4	51.8	:	54.3	54.7	55.1	:
Employment rate for older workers ⁹	25.1	26.6	28.1	:	37.4	38.8	40.2	:
Long-term unemployment ¹⁰	3.2	3.5	3.7	:	3.8	3.9	4.0	:
Tax rate on low wage earners ¹¹	49.1	48.5	47.5	:	37.2	37.1	37.4	:
Unemployment trap indicator ¹²	88.8	91.3	90.3	:	78.8	78.5	78.3	:
Product market reforms								
Hourly labour productivity ¹³	120.2	119.8	120.9	:	:	:	:	:
Total trade to GDP ratio ¹⁴	:	97.5	94.8	:	:	58.8	57.2	:
Internal Market Directives ¹⁵	97.7	98.0	96.5	96.4	:	:	:	96.3
Business investment ¹⁶	19.3	18.2	17.9	:	17.9	17.2	16.8	:
Knowledge-based economy								
Total tertiary graduates ¹⁷	53.4	55.9	:	:	46.8	:	:	:
Spending on human resources ¹⁸	6.1	:	:	:	5.1	:	:	:
R&D expenditure ¹⁹	2.2	2.2	2.3	:	1.9	1.9	:	:
Expenditure on IT ²⁰	3.4	3.1	2.9	2.9	3.1	2.9	2.9	2.9

¹ Growth rate in percentage.

² Annual average rate of change in harmonised index of consumer prices in percentage.

³ Growth rate of real GDP per occupied person in percentage.

⁴ Growth rate of compensation per employee.

⁵ As a percentage of GDP.

⁶ Number of unemployed as a percentage of the labour force.

⁷ Employed persons aged 15-64 as a share of the total population of the same age group.

⁸ Employed women aged 15-64 as a share of the total female population of the same age group.

⁹ Employed persons aged 55-64 as a share of the total population of the same age group.

¹⁰ Long-term unemployed (over 12 months) as a percentage of the total active population aged 15-64.

¹¹ Income tax plus employer/employee contributions as a percentage of labour costs of a single earner at 67% of the Average Production Worker-wage, no children.

¹² Effective tax rate on labour income taking into account the combined effect of increased taxes and benefits withdrawal as an individual moves from unemployment back to work earning 67% of the Average Production Worker-wage, measured at the first month of unemployment (after any 'waiting period' if applicable).

¹³ GDP per hour worked in PPS, EU-15=100.

¹⁴ Percentage, average value of imports and exports of goods and services divided by GDP, multiplied by 100. For DE, ES, FR, IT, PL and the UK the value for EU-25 is the total for the large Member States, for all the other states the value for EU-25 is the total for the small Member States.

¹⁵ Percentage implemented in November 2004.

¹⁶ Gross fixed capital formation by the private sector as a percentage of GDP.

¹⁷ Total tertiary graduates (ISCED 5-6) per 1000 of population aged 20-29.

¹⁸ Public expenditure on education as a percentage of GDP.

¹⁹ GERD Gross domestic expenditure on R&D as a percentage of GDP.

²⁰ Expenditure on information technology as a percentage of GDP.

Source: Commission services (incl. Eurostat, structural indicators)

The data for 'general economic background' and 'public finance' are taken from the Commission's Autumn 2004 Economic Forecasts.

2. CZECH REPUBLIC

Introduction

In 2004, the Czech Republic experienced a strong economic performance driven mainly by buoyant investment and strong, but weakening consumption. The outlook for economic activity remains favourable over the medium term. The key policy challenge for the Czech economy is sustainable public finances. Despite the strong GDP growth, the general government deficit remains well above 4 per cent of GDP. The Czech economy displays a number of structural weaknesses as well. The labour market is rigid and it has so far been slow to react to the pick-up in economic activity. There are imperfections in the business environment and productivity growth per person employed over the period 2000-2003 was relatively low at around 2.5 per cent which was one of the lowest growth rates among the new Member States. Nevertheless, productivity growth rates in 2003 and especially in 2004 seem to be encouraging. The key reform area in 2004 was to start the process of consolidation of public finances. After the nearly two-months-long government crisis, a new government was confirmed by the Parliament in August 2004. It consists of the same parties and it is again supported by the narrowest possible majority (101 out of 200 seats in the Parliament). The new government mostly reaffirmed the priorities of the previous one: to accelerate economic growth, to reduce unemployment, to support families with children, to fight against corruption and to continue the consolidation of public finances. The new government has also stressed its commitment to proceeding with structural reforms. There are several proposals in the pipeline to deal with the outstanding weaknesses of the business environment. Furthermore, reform of the education system is being discussed and the government is in the process of formulating its R&D and innovation policy and the appropriate measures to implement it. A detailed assessment of recent developments in addressing the Czech Republic's key policy challenges is presented in the following sections.

1. Public finances

Urgently ensure a further reduction of the general government deficit on a sustainable basis and the long-term sustainability of public finances

Under this challenge, the Czech Republic was requested to:

1. reduce the general government deficit in a credible and sustainable way within a multi-annual framework in line with the decisions to be taken by the Council in the context of the forthcoming budgetary surveillance exercise (GL 1); and
2. reform the health care and pension systems to ensure their financial sustainability, in particular to counter the expected increase in the old-age dependency ratio and take measures to reduce fiscal risk stemming from the rising stock of contingent liabilities; and to ensure that incentives to work are enhanced and the high social security contribution rates are lowered (GL 4, 14 and 16).

A successful beginning of the medium-term fiscal consolidation...

On 5 July 2004, the Council decided that the Czech Republic was in excessive deficit and recommended that this be corrected by 2008 at the latest. Specifically, the Czech Republic was required to implement with vigour the measures envisaged in the May 2004 convergence programme, in particular to introduce fiscal targeting based on medium-term expenditure ceilings, to design effective rules to reduce the risk of increasing indebtedness of regions and municipalities and to allocate higher-than-budgeted revenues to deficit reduction. Several laws were passed in the second half of 2003 and in April 2004, for instance the law on changes in VAT and in excise duties and the laws introducing savings in pension and sickness expenditures. Reforms of expenditures and revenues were accompanied

by the creation of a new institutional framework for budgetary planning. In summer 2004, the Czech Parliament passed a law on new budgetary rules which introduced fiscal targeting based on medium-term expenditure ceilings for central government. With each annual budget for year n , the Parliament will approve nominal expenditure ceilings for years $n+1$ and $n+2$. Any later review of the ceilings is allowed only in situations explicitly mentioned in the law on budgetary rules. However, the medium-term ceilings apply only to the central government expenditure. As concerns regional governments and municipalities, legal constraints on their indebtedness may not be sufficient to discourage them from excessive deficits and debt. The 2004 deficit target of 5.3 per cent of GDP is likely to be achieved, despite an imputation of a state guarantee of about 0.8 per cent of GDP. Without the imputed state guarantee, the deficit target would be over-achieved, mainly due to higher-than-expected revenues against the backdrop of a strong economic performance. The expenditure ceilings will become legally binding only in 2006, but the 2005 state budget to a large extent respected them and the deficit target for 2005 of 4.7 per cent of GDP is likely to be met as well. Although the strong economic performance makes fiscal consolidation easier, the government should stick to its original plans and concentrate on expenditure cuts. Important savings, particularly regarding government consumption, still need to be agreed upon to comply with the deficit target for 2006 of 3.8 per cent of GDP.

...but important decisions concerning the long-term sustainability are still pending.

The Czech Republic faces serious risks of budgetary imbalances in meeting the cost of an ageing population. So far, policy measures have concentrated on parametric changes of the pension and healthcare systems. Those measures are insufficient to secure the long-term sustainability of public finances and further measures are needed. The government recently set up an experts' group to prepare different proposals of pension reform. The government is determined to choose one of the pension reform proposals and to decide on it before the 2006 parliamentary elections. On the contrary, the health-care reform which was started by the previous government was put on hold. Contingent liabilities linked to the indebtedness of public hospitals and to the "environmental clean-up guarantees" granted to privatised industrial firms by the National Property Fund remain.

2. Labour market

Continue to address the structural problems in the labour market

Under this challenge, the Czech Republic was requested to:

3. strengthen labour supply by reforming tax benefit systems to eliminate disincentives to work and enhance occupational and regional mobility by reducing skill mismatches, whilst ensuring the efficiency of retraining measures and other active labour market policies, deregulating the housing market, and improving transport infrastructure (GL 4, 7, 8 and 13).

Several steps in the right direction adopted...

The main structural weaknesses of the Czech labour market are low mobility of the labour force between jobs and regions, too generous social benefit system, high taxation of labour and an inadequate system of higher education. As a part of the fiscal consolidation package, replacement rates of sickness benefits were cut in the first three days of sickness and obligation of doctors to make responsible decisions when granting sick leaves was reinforced. A new Employment Act which entered into force on 1 October 2004 introduced several positive changes into the labour market policy. For instance, there is a new regulation of private unemployment agencies and the law introduces the possibility of "partial unemployment." Registration as unemployed and provision of unemployment benefits becomes stricter. On the other hand, the new law introduced a prolongation of

unemployment benefits from six to nine months for those older than 50 years and to twelve months for those older than 55 years. The new Employment Act also includes several changes in the active labour market policy like training of employees if it is necessary for them to keep the job; investment subsidies for employers creating new jobs; subsidised public works; additional support for workers with disabilities; bridging subsidy for newly self-employed which have been registered as unemployed etc. On 1 May 2004, the rules for granting investment incentives were changed in such a way that entrepreneurship in the structurally weak regions with high unemployment should be better promoted. Moreover, the government adopted a programme to promote the creation of new jobs in districts where the rate of registered unemployment exceeds 14 per cent. To combat youth unemployment, the government launched a special programme for young job seekers to increase their employability.

...but more profound measures still remain to be taken.

However, many of the causes of structural shortcomings in the labour market have not yet been tackled. The system of social benefits is still too generous and contributes to inactivity, particularly of low-wage workers. The highest negative impact of parenthood on the employment of women in the EU (38.9 per cent, compared to the EU average of 13.6 per cent) remained unaddressed. The process of deregulation of housing rents was put on hold due to the lack of political consensus. In the short period of time, very little progress was achieved in improving transport infrastructure which remains a serious constraint both for labour force mobility and for settlement of new businesses in structurally weak regions.

3. Productivity

Improve conditions for an accelerated productivity growth

Under this challenge, the Czech Republic was requested to:

4. improve the efficiency and quality of the education and training system and its responsiveness to changing skills requirements; and
5. improve the efficiency of R&D and innovation activities, foster the transfer of knowledge through FDI and support the diffusion of knowledge.

A profound reform of the education system is still missing...

The progress in reforming the education system has been very limited. The resources for education remain at very low levels. The overall public education expenditures fluctuate at around 4.5 per cent of GDP and there is no prospect of significant increases in the near future.

The Parliament has approved a new Education Act covering the primary and elementary education which should bring about a reform of the curriculum. The Act should increase the autonomy of schools and shift emphasis towards flexibility and adaptability of skills and competencies. Due to the lack of financial resources the government has postponed a reform of tertiary education. The proposed reform was intended to increase the number of tertiary graduates, improve their practical skills, support research at the universities and increase the expenditures on tertiary education from 0.9 per cent of GDP to 1.2 per cent. The new government refused to open a debate on the introduction of university fees.

...and the progress on R&D and innovation is piecemeal.

The authorities recognise that the effectiveness of R&D activities and the diffusion of know-how continue to be a problem. The overall spending on R&D reached 1.3 per cent of GDP in

2003. The government is considering ways to boost private spending on R&D. The main tool is intended to be the tax-deductibility of R&D expenditures. The volume of public spending (excluding the tax expenditure on R&D) is not expected to exceed 0.6 per cent of GDP in the coming two years. In 2004, the government adopted the National R&D Policy for 2004-2008 and the National Innovation Policy. The implementation plan is to be discussed by the government in the first half of 2005. Furthermore, legislation improving the institutional framework for public research institutions was adopted.

The Czech Republic has enjoyed significant FDI inflows which have probably contributed to knowledge transfer. In order to attract investments into advanced technologies and high value-added activities, the government has adopted a programme of investment incentives for technological centres and strategic services (e.g. call centres, headquarters). This project has received a good response and is thought to generate further pressure on enhancing the quality of human capital.

4. Entrepreneurship and SMEs

Promote entrepreneurship and SMEs

Under this challenge, the Czech Republic was requested to:

6. improve the business climate by, in particular, removing administrative burdens, improving and enforcing the legal framework and increasing access to finance.

Measures to improve the business environment are in the pipeline...

The Czech government seems determined to promote entrepreneurship and improve the business environment. As regards the institutional setup, the Investment and Business Development Agency (CzechInvest) was created by merging several existing agencies in order to increase the effectiveness of the support for entrepreneurship and the use of EU funds. Furthermore, the Business Environment Development Council was founded with the aim of proposing measures to improve the business environment. As regards the concrete measures, there are proposals to tackle barriers to market entry and exit and to reduce administrative burden. The Parliament is discussing legislative proposals to speed up the registration of companies by setting strict time limits and introducing unified forms. The Parliament is also considering amendments to the bankruptcy legislation aimed at improving the position of creditors. At the same time, a completely new Bankruptcy Act is being prepared which should significantly shorten the bankruptcy proceedings, strengthen the position of creditors and allow, if still viable, for restructuring of the troubled company. A project to introduce one-stop-shops for entrepreneurs is being finalised. It should be fully operational as of 2006. The general rate of corporate income tax is being gradually reduced from 31 per cent in 2003 to 24 per cent in 2006.

... but the implementation is rather slow, and

However, besides the institutional changes and some reported improvements in the operation of the Commercial Register which have resulted in some reduction in the time needed to complete a registration, very few measures have actually been implemented.

... the situation of SMEs has not changed significantly yet.

The value-added generated by the SME continues to slightly exceed 52 per cent of the total output, to be compared with 57 per cent for the EU. The system of SME support has been somewhat adjusted to accommodate the resources from the EU funds. Additional impetus is expected to be given by the government's innovation strategy. The functioning of the credit register has improved the access of businesses to finances. On the other hand, the introduction of the minimum compulsory tax for entrepreneurs seems to have reduced the number of self-employed somewhat.

Table 2.1: Economic indicators for the Czech Republic

	Czech Republic				EU-25			
	2001	2002	2003	2004	2001	2002	2003	2004
General economic background								
Real GDP growth ¹	2.6	1.5	3.1	3.8	1.8	1.1	1.0	2.5
Inflation ²	4.5	1.4	-0.1	2.8	2.5	2.1	1.9	2.2
Labour productivity growth ³	2.2	0.0	3.3	4.7	0.8	0.9	0.9	2.1
Employment growth ¹	0.4	1.5	-0.2	-0.9	1.0	0.3	0.3	0.4
Nominal wage growth ⁴	7.6	6.2	6.7	6.4	4.0	3.2	3.1	3.0
Current account ⁵	-5.4	-5.6	-6.2	-6.1	:	:	:	:
Unemployment ⁶	8.0	7.3	7.8	8.3	8.5	8.9	9.1	9.1
Public finance								
General government balance ⁵	-5.9	-6.8	-12.6	-4.8	-1.2	-2.3	-2.8	-2.8
Primary balance ⁵	-4.8	-5.2	-11.3	-3.6	2.4	1.0	0.3	0.2
Cyclically-adjusted balance ⁵	:	:	:	:	:	:	:	:
Gross government debt ⁵	25.3	28.8	37.8	37.8	62.1	61.6	63.2	63.5
Employment								
Employment rate ⁷	65	65.4	64.7	:	62.8	62.9	63.0	:
Female employment rate ⁸	56.9	57	56.3	:	54.3	54.7	55.1	:
Employment rate for older workers ⁹	37.1	40.8	42.3	:	37.4	38.8	40.2	:
Long-term unemployment ¹⁰	4.1	3.7	3.8	:	3.8	3.9	4.0	:
Tax rate on low wage earners ¹¹	41.6	41.8	42	:	37.2	37.1	37.4	:
Unemployment trap indicator ¹²	67.2	67	66.3	:	78.8	78.5	78.3	:
Product market reforms								
Hourly labour productivity ¹³	44.7	45.5	48.9	:	:	:	:	:
Total trade to GDP ratio ¹⁴	67.7	62.5	63.4	:	:	58.8	57.2	:
Internal Market Directives ¹⁵	:	:	:	90.1	:	:	:	96.3
Business investment ¹⁶	24.3	22.9	22.4	:	17.9	17.2	16.8	:
Knowledge-based economy								
Total tertiary graduates ¹⁷	25.4	25.7	:	:	46.8	:	:	:
Spending on human resources ¹⁸	4.2	4.4	:	:	5.1	:	:	:
R&D expenditure ¹⁹	1.2	1.2	1.4	:	1.9	1.9	:	:
Expenditure on IT ²⁰	3.3	3.1	3.4	3.4	3.1	2.9	2.9	2.9

¹ Growth rate in percentage.

² Annual average rate of change in harmonised index of consumer prices in percentage.

³ Growth rate of real GDP per occupied person in percentage.

⁴ Growth rate of compensation per employee.

⁵ As a percentage of GDP.

⁶ Number of unemployed as a percentage of the labour force.

⁷ Employed persons aged 15-64 as a share of the total population of the same age group.

⁸ Employed women aged 15-64 as a share of the total female population of the same age group.

⁹ Employed persons aged 55-64 as a share of the total population of the same age group.

¹⁰ Long-term unemployed (over 12 months) as a percentage of the total active population aged 15-64.

¹¹ Income tax plus employer/employee contributions as a percentage of labour costs of a single earner at 67% of the Average Production Worker-wage, no children.

¹² Effective tax rate on labour income taking into account the combined effect of increased taxes and benefits withdrawal as an individual moves from unemployment back to work earning 67% of the Average Production Worker-wage, measured at the first month of unemployment (after any 'waiting period' if applicable).

¹³ GDP per hour worked in PPS, EU-15=100.

¹⁴ Percentage, average value of imports and exports of goods and services divided by GDP, multiplied by 100. For DE, ES, FR, IT, PL and the UK the value for EU-25 is the total for the large Member States, for all the other states the value for EU-25 is the total for the small Member States.

¹⁵ Percentage implemented in November 2004.

¹⁶ Gross fixed capital formation by the private sector as a percentage of GDP.

¹⁷ Total tertiary graduates (ISCED 5-6) per 1000 of population aged 20-29.

¹⁸ Public expenditure on education as a percentage of GDP.

¹⁹ GERD Gross domestic expenditure on R&D as a percentage of GDP.

²⁰ Expenditure on information technology as a percentage of GDP.

Source: Commission services (incl. Eurostat, structural indicators)

The data for 'general economic background' and 'public finance' are taken from the Commission's Autumn 2004 Economic Forecasts.

3. DENMARK

Introduction

After the subdued economic activity in 2003, GDP growth should be some 2¼ per cent in 2004 and 2005, mainly driven by domestic demand. In particular, in 2004 private consumption was boosted by direct and indirect tax cuts as well as the suspension of contributions to a mandatory pension savings scheme. As a part of the spring 2004 fiscal package, the income tax cuts of the tax reform were accelerated and fully implemented in 2004. The labour market turned in 2004, with employment recovering modestly after the marked fall in 2003. Overall, economic policy remains focused on medium-term objectives, addressing the broader challenge of ensuring the financing of the expected future increase in net public expenditures due to ageing, without the need for a fiscal tightening at some later point. The strategy pursued consists of reducing the public debt ratio substantially by 2010, through running significant general government surpluses while at the same time lowering the tax burden with a view to increasing labour supply and output potential. The fiscal targets are overall being met and Denmark's public finances are thus sound. The medium-term fiscal projections, however, assume significant increases in the labour supply and this challenge has so far been less forcefully addressed. To present reform proposals related to the future financing and design of the welfare system, the so-called Welfare Commission was set up in 2004. In recent years productivity per hour in Denmark has been generally above the EU-15 average, both in terms of level and growth. However, according to an OECD survey carried out in July 2004, Denmark continues to have the highest prices in the EU. There are likely to be numerous factors behind the sustained high price level, but one element may be weak competition in some sectors of the economy. In 2002 the government set a target of halving the number of markets with competition problems by 2010. It has already made some progress towards this target and proactive efforts by the Danish Competition Authority should help the situation to improve further, not least in the area of government regulations that distort competition. A detailed assessment of recent developments in addressing Denmark's key policy challenges is presented in the following sections.

1. Long-term sustainability of public finances

Ensure an adequate labour supply in view of the ageing of the population	Assessment
Under this challenge, Denmark was requested to:	
1. continue efforts to increase labour supply notably by efforts to make work pay by increasing incentives to join and remain in the labour force and to postpone retirement, in particular by ensuring the implementation of the tax reform and by considering additional steps to tighten eligibility rules and reduce marginal taxes within a framework of sound public finances (GL 4); and	In progress
2. ensure expenditure control at all levels of government so that the multi-annual targets for public consumption growth are respected (GL 14).	In progress
Bearing in mind the three-year period available for implementation, the degree of implementation since 2003 is indicated as: "Complete" for (practically) complete; "In progress" where progress is well advanced; "Limited" where the recommendation is only partially addressed and "Insufficient" where no substantial measures going in the right direction have been taken.	

Measures to enhance labour supply have been taken in recent years...

As reviewed in the 2004 Implementation Report, earlier reform efforts have gone in the right direction and should have a positive effect on labour supply. The 2003 “More people into employment” initiative includes more results-oriented activation measures and strengthened economic incentives for groups benefiting from social assistance. In addition, availability and willingness-to-work criteria have been tightened. The recent tax reform, fully implemented in 2004, lowers marginal taxes by approximately 6 percentage points for about a quarter of the workforce by raising the threshold for the medium tax bracket which should raise the incentives for many to work more hours. In addition, an earned income tax credit has been introduced to enhance incentives for low-wage earners to stay in or enter the labour market. Even after the recent reform, however, the top marginal rate of 63 per cent still applies to around 40 per cent of full time workers. Moreover, while contributing to raising labour supply, the tax cuts are not self-financing and thus do not *per se* improve long-term fiscal sustainability. The agreement to lower taxes was financed within the framework of the original 2010 plan (dating from January 2001), partly by making use of the built-in room for tax-reductions, and partly by lowering expenditure targets.

... but the needed future reforms have yet to be specified

The effects of already implemented measures take time to come through and it is too early to fully evaluate their impact. In spite of earlier reforms the unemployment benefit duration remains long in an EU context. This could reduce the effectiveness of active labour market policies. Although activation does not entitle to new benefit periods and willingness-to-work criteria are strict, the remaining duration of unemployment benefits has provided an easy return to benefit reciprocity, often resulting in only short employment periods for low-wage earners. Regarding older workers, the 1999 reform of the voluntary early retirement benefit scheme is having some positive effects on the labour supply of persons aged 60-62 years. However, by reducing or delaying entry via economic incentives rather than restricting access, the reform was limited and the scheme thus remains an obstacle to raising labour market participation for the over-60s. All in all, as recognised by the Danish authorities, further efforts will be needed to reach the medium-term targets for labour supply. The content of further reforms has not yet been spelled out.

The targets for public expenditure growth have been exceeded...

Over the last decade, the average growth of public consumption expenditure in real terms has been some 2 per cent. The target set for 2002 and 2003 was an average growth of 1 per cent over the two years. The outcome, however, was 2.1 per cent and 1.0 per cent, respectively, thus in excess of the target but with a downward trend. The target for 2004 was 0.7 per cent and from 2005 still stricter at ½ per cent. Achieving the targets for public expenditure restraint is important for the medium-term fiscal targets in general, and also for the credibility of the strategy of income tax reductions, as the potential fiscal leeway for the tax cuts has been created in part by lowering the projected future growth of real public consumption expenditure in 2004 and 2005.

...but public expenditure control is becoming more effective

As the largest share of public consumption is the responsibility of the counties and municipalities, fulfilling the targets for the general government finances will require discipline in adhering to the agreements across all government levels. In addition to the budget agreements across government levels, the tax freeze is a key factor in this respect. Local governments have autonomous taxing powers but are restricted in raising capital via loans. In this perspective the tax freeze aims at preventing local governments from raising taxes to finance increased spending. In 2004, real public consumption is expected to have

grown only modestly, which could indicate that a more effective control of public expenditure has been established. Moreover, the local government budgets for 2005 imply that the tax freeze is overall respected. In view of past trends, however, the target of ½ per cent growth of real public consumption remains ambitious.

2. Productivity and business dynamism

Enhance competition in certain sectors and improve the efficiency of the public sector	Assessment
Under this challenge, Denmark was requested to:	
3. step up efforts to enforce competition in sectors where it is inadequate (GL 9); and	In progress
4. continue efforts to increase the efficiency of the public sector, <i>inter alia</i> by improving framework conditions for increased competition, promoting the benchmarking of public sector efficiency, and by increasing public tendering (GL 11).	In progress

Efforts are being made to improve competition in sectors where there are problems...

Prices in Denmark remain the highest in the EU and this may be due in part to weak competition in some parts of the economy. The Danish Government has made clear its commitment to improving competition throughout the economy by setting long term targets for reducing the number of sectors with competition problems and by conferring extra powers on the Danish Competition Authority. Since 2002 the Competition Authority has had the power to impose fines large enough to have a deterrent effect on undertakings in breach of competition law and in 2004 the Danish Competition Act was updated to bring it into line with the modernisation of EU competition law. The Competition Authority has been proactive in identifying markets where problems exist. In 2004 a report was published which identified sectors, such as the legal profession, the housing sector, and taxi services, where competition is distorted by regulations. The report makes recommendations for change in some sectors, and suggests further investigation in others.

...and moves to increase public sector efficiency are continuing.

In 2004 the decision was made to completely overhaul the municipal system of government with the aim of *inter alia* improving efficiency. The implementation of the changes is planned to take place in 2007. The number of municipalities is expected to be reduced from 271 to around 100. The new larger municipal units should allow the exploitation of scale efficiencies. Significant efficiency gains are expected by the Danish authorities from the transfer to central government of the responsibility for tax collection and recovery of debts owed to public authorities. However, some concerns might be raised on whether the increased decentralisation might ultimately reduce efficiency in certain areas if new administrative units are created to replace the present county administrations

Also in 2004 a cross-government initiative was launched to investigate how public sector roles can be modernised and where possible delegated to the private sector. As part of its action plan for public private partnerships, the government has introduced a requirement to test all public sector building and construction projects for their appropriateness as public-private partnerships.

Table 3.1: Economic indicators for Denmark

	Denmark				EU-25			
	2001	2002	2003	2004	2001	2002	2003	2004
General economic background								
Real GDP growth ¹	1.6	1.0	0.5	2.3	1.8	1.1	1.0	2.5
Inflation ²	2.3	2.4	2.0	1.1	2.5	2.1	1.9	2.2
Labour productivity growth ³	1.3	1.4	1.4	1.9	0.8	0.9	0.9	2.1
Employment growth ¹	0.3	-0.4	-0.9	0.4	1.0	0.3	0.3	0.4
Nominal wage growth ⁴	4.6	3.2	3.6	3.3	4.0	3.2	3.1	3.0
Current account ⁵	3.1	2.0	2.9	3.2	:	:	:	:
Unemployment ⁶	4.3	4.6	5.6	5.8	8.5	8.9	9.1	9.1
Public finance								
General government balance ⁵	2.1	0.7	0.3	1.0	-1.2	-2.3	-2.8	-2.8
Primary balance ⁵	5.4	3.6	2.9	3.3	2.4	1.0	0.3	0.2
Cyclically-adjusted balance ⁵	0.9	0.5	1.2	1.5	:	:	:	:
Gross government debt ⁵	49.2	48.8	45.9	43.4	62.1	61.6	63.2	63.5
Employment								
Employment rate ⁷	76.2	75.9	75.1	:	62.8	62.9	63.0	:
Female employment rate ⁸	72.0	71.7	70.5	:	54.3	54.7	55.1	:
Employment rate for older workers ⁹	58.0	57.9	60.2	:	37.4	38.8	40.2	:
Long-term unemployment ¹⁰	0.8	0.9	1.1	:	3.8	3.9	4.0	:
Tax rate on low wage earners ¹¹	40.6	39.9	39.9	:	37.2	37.1	37.4	:
Unemployment trap indicator ¹²	93.7	93.1	92.7	:	78.8	78.5	78.3	:
Product market reforms								
Hourly labour productivity ¹³	101.7	99.9	101.9	:	:	:	:	:
Total trade to GDP ratio ¹⁴	44.1	44.6	42.4	:	:	58.8	57.2	:
Internal Market Directives ¹⁵	99.2	99.3	99.7	97.5	:	:	:	96.3
Business investment ¹⁶	18.4	18.9	18.2	:	17.9	17.2	16.8	:
Knowledge-based economy								
Total tertiary graduates ¹⁷	55.2	:	:	:	46.8	:	:	:
Spending on human resources ¹⁸	8.5	8.5	:	:	5.1	:	:	:
R&D expenditure ¹⁹	2.4	2.5	2.6	:	1.9	1.9	:	:
Expenditure on IT ²⁰	3.8	3.5	3.4	3.4	3.1	2.9	2.9	2.9

¹ Growth rate in percentage.

² Annual average rate of change in harmonised index of consumer prices in percentage.

³ Growth rate of real GDP per occupied person in percentage.

⁴ Growth rate of compensation per employee.

⁵ As a percentage of GDP.

⁶ Number of unemployed as a percentage of the labour force.

⁷ Employed persons aged 15-64 as a share of the total population of the same age group.

⁸ Employed women aged 15-64 as a share of the total female population of the same age group.

⁹ Employed persons aged 55-64 as a share of the total population of the same age group.

¹⁰ Long-term unemployed (over 12 months) as a percentage of the total active population aged 15-64.

¹¹ Income tax plus employer/employee contributions as a percentage of labour costs of a single earner at 67% of the Average Production Worker-wage, no children.

¹² Effective tax rate on labour income taking into account the combined effect of increased taxes and benefits withdrawal as an individual moves from unemployment back to work earning 67% of the Average Production Worker-wage, measured at the first month of unemployment (after any 'waiting period' if applicable).

¹³ GDP per hour worked in PPS, EU-15=100.

¹⁴ Percentage, average value of imports and exports of goods and services divided by GDP, multiplied by 100. For DE, ES, FR, IT, PL and the UK the value for EU-25 is the total for the large Member States, for all the other states the value for EU-25 is the total for the small Member States.

¹⁵ Percentage implemented in November 2004.

¹⁶ Gross fixed capital formation by the private sector as a percentage of GDP.

¹⁷ Total tertiary graduates (ISCED 5-6) per 1000 of population aged 20-29.

¹⁸ Public expenditure on education as a percentage of GDP.

¹⁹ GERD Gross domestic expenditure on R&D as a percentage of GDP.

²⁰ Expenditure on information technology as a percentage of GDP.

Source: Commission services (incl. Eurostat, structural indicators)

The data for 'general economic background' and 'public finance' are taken from the Commission's Autumn 2004 Economic Forecasts.

4. GERMANY

Introduction

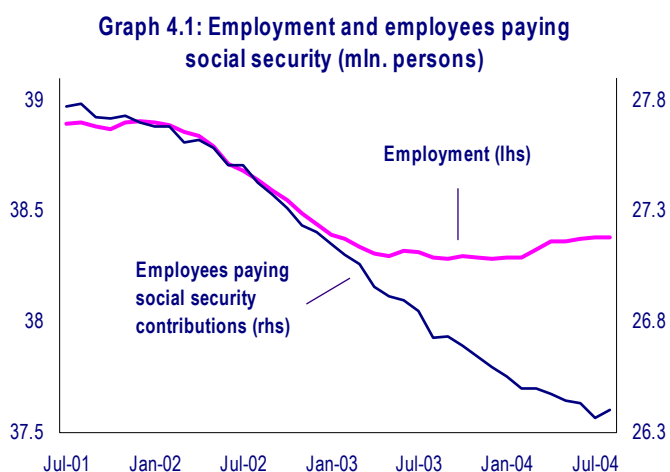
In 2004, GDP grew at a solid pace of nearly 2 per cent, thus bringing a long stagnation to an end. However, the recovery so far relied almost exclusively on external demand. Domestic demand even shrank, reflecting weak business and consumer confidence as well as stagnating wages. As a result of this lop-sided demand pattern, public finances failed to improve substantially with the deficit in 2004 barely below 4 per cent of GDP, practically unchanged from 2003. The reluctance of German households and companies to spend contrasts with the far-reaching structural reform programme launched by the government in March 2003, which in the medium-term should improve Germany's growth potential. Since the reform programme is largely addressing the labour market and social security systems, public controversies over implementation details overshadowed the progress of reform. Public finances benefited from the reform, insofar as nominal expenditure remained flat in 2004. Based on the additional measures adopted by the government in late 2004, it may be expected that, despite revenue shortfalls, the deficit can be brought below 3% of GDP in 2005. No significant action has been taken by the government to ensure that wages reflect productivity differentials across skills and regions, besides encouraging social partners to make greater use of opening clauses in collective agreements. Only some progress has been made in the health sector and in the education system. Also, the blurred allocation of decision powers between different levels of government often impeded finding a common approach on reform progress between the different levels of public authorities. The delays in the transposition of Internal Market (IM) Directives into national law and the different approaches taken to address the weaknesses in the German education system are examples. Nonetheless, the majority of the recent reforms goes into the right direction, and it is reassuring that the authorities are ready to review policy settings on a broad front e.g. with active labour market policy. A detailed assessment of recent developments in addressing Germany's key policy challenges is presented in the following sections.

1. Labour market and regional development

Promote job creation and adaptability and mobilise the unutilised employment potential	Assessment
Under this challenge, Germany was requested to:	
1. continue to reform the tax-benefit system (GL 4), in order to ensure sufficient incentives to take up work or to move into a higher income bracket, and firmly enforce the conditionality of benefits upon active job search;	In progress
2. take measures to ensure that wages reflect better productivity differences across skills and regions (GL 5), notably by reviewing the Günstigkeitsprinzip, allowing temporarily lower payments for job starters; and	Limited
3. carry forward the reforms to improve the efficiency of ALMPs, in particular of job search assistance. Further reform ALMPs according to cost-effectiveness criteria and target them better towards those persons most prone to the risk of long-term unemployment (GL 8, 13 iv).	In progress
Bearing in mind the three-year period available for implementation, the degree of implementation since 2003 is indicated as: "Complete" for (practically) complete; "In progress" where progress is well advanced; "Limited" where the recommendation is only partially addressed and "Insufficient" where no substantial measures going in the right direction have been taken.	

Implementation of a large reform programme...

As reviewed in the 2004 Implementation Report, Germany has March 2003 been passing legislation to reform the labour market, with implementation taking place over 2003 – 2005. The reforms comprised the four laws on “modern services in the labour market” (“Hartz I to IV”), modifying the framework and the instruments of labour market policy in a fundamental way. Furthermore, the “law on labour market reforms” relaxed slightly the dismissal protection rules, and a reform of the regulation of crafts eased the qualification requirements needed to open up a business. The year 2004 was characterised by the implementation of these measures. Labour market reforms already implemented are showing first effects, with the rapid increase in low-skilled jobs subject to reduced social security contributions, bringing the overall decline in employment to a halt (see graph). Between mid-2001 and mid-2003 employment in Germany had fallen by ½ million from 38.9 to 38.4 million. Recently, the figure has edged up by some 100 000 from a low in autumn of 2003, in spite of still subdued GDP growth. By contrast, over the same three years, the number of



employees paying social security contributions has dropped by 1½ million with no indication of bottoming out. The fall in the number of persons paying social security contributions is one of the reasons for the deterioration of public finances. The government has commissioned a comprehensive evaluation of the individual measures and of their overall effects – to be undertaken by independent research institutes by 2006 – with first results expected before the end of 2005.

... but incentives could be strengthened further

The recommendation to reform the tax-benefit system addresses two issues in particular. First, persons not in the labour force find it unattractive to take up low-paid work due to high contribution rates to social security. Second, social transfers are usually tied to the recipient being out of work, thus unemployed face high marginal tax rates upon taking up a job. 2004 data seem to show that the first problem has been addressed by recent reforms, whereas this was less the case for the second (and more important) problem. So-called *Minijobs*, paying up to €400 a month, exempt the worker from social security contributions, while *Midijobs*, paying between €400-800, only ‘phase-in’ social security contributions. Since their introduction on 1.3.2003, their number has been rising. However, the number of employees paying social security contributions has fallen and unemployment did not change much. This indicates that these jobs may have proved largely attractive to persons outside the labour force. There is no clear evidence that this trend is coming to a halt. Whether *Minijobs* crowd out regular jobs or whether they create additional job opportunities, cannot yet be determined on the basis of existing studies. Since they are subject to reduced social security contributions and unemployment is hardly going down, *Mini- / Midijobs* may aggravate the funding problems of social security systems. With the new social benefit (*ALG II*) in 2005, the opportunities for earning income in addition to transfers are being extended. Although still between 70-85% of the transfer income is being withdrawn upon taking up low-paid work, the level of income at which transfers are withdrawn entirely has been raised considerably.

Despite the transfer trap, incentives to take up work are strengthened by the reorganisation of the benefit structure in 2005 (“Hartz IV”), which involves some expenditure cuts (e.g. for housing aid) and stricter rules for transfer payments. Although the reform was legislated at the end of 2003, the organisational aspects of this reform were fixed only late in 2004, which is likely to result in administrative problems at the time of introduction in 2005. The reduction in the benefits will not eliminate the unemployment trap fully, but will improve incentives to take up work paying marginally above the transfer income. In particular, workers will be forced to accept any job offer paying up to 30 per cent less than the prevailing local wage; otherwise they stand to lose their benefit entitlement eventually.

Progress was made in 2004 as to the reduction of active labour market programmes with poor results from evaluation. Also, employment in the secondary labour market no longer creates further claims to unemployment benefits. A different type of secondary employment, but without the fiction of regular employment, is being substantially extended in 2005. Such so-called “one-euro-jobs” are unskilled jobs against an expense allowance for their holders, which are not meant to replace jobs offered on the market. These jobs can be offered on a compulsory basis to recipients of ALG II by their local counsellor; if declined, the social assistance is eventually lost. These jobs may reinforce incentives for unemployed to seek regular work, if the local job centres indeed use them in this ‘workfare’ manner. However, there are grave risks of inefficiency. Although “one-euro-job” holders remain liable to accepting any regular job, they will often disappear from the unemployment statistics, improving “the record” of their local counsellor. Both the job holders and the local governments that offer such jobs are fully compensated for their expenses by the Federal Employment Agency. The Agency does not require the employer to assume part of the social benefits that it continues to fully pay to the job holder.

Evidence on two further measures from the Hartz-package aiming at the primary labour market, both introduced on 1.1.2003, has become available in 2004. As of end of November 2004, 870 *Personal-Service-Agenturen* (PSAs), which are temporary employment and training agencies taking on for 12 months unemployed that are difficult to integrate into the labour market, had been established, employing around 36400 formerly unemployed (against a target of 50 000). Since their creation a total of about 67 000 persons had left the PSAs, of which about 20 000 persons found regular work. The number of *Ich-AGs*, a scheme providing subsidies to unemployed when becoming self-employed, had risen to 181 000 in November 2004. However, the scheme was criticised for the unconditional approval of applications. From November 2004 onwards, the business plans submitted by new applicants are being scrutinised more closely. It remains to be seen whether this will make this start-up scheme more efficient.

No reform of wage bargaining

Wage agreements were moderate in 2004, accompanied by a negative wage drift. Encouraged by the government, wage agreements increasingly contain opening clauses that allow for de facto wage cuts in exchange for job guarantees. These are, however, most often conditional on the agreement by the social partners at the industry-level. Several large firms with a firm-level wage agreement also concluded such deals. Moreover, especially in eastern Germany, wage contracting lost importance as the social partner organisations are losing members. This is evidence for the pressure for greater wage differentiation at the firm-level. Notably, the recent behaviour of social partners can be seen as the first practical deviation from the prevailing interpretation of the *Günstigkeitsprinzip*, which according to the union wage contract law (*Tarifvertragsgesetz*) allows deviations from the union wage contract only if this is to the worker’s benefit. In the past, courts had interpreted this rule such that firm-level agreements on wage cuts against job guarantees do not warrant a deviation from the industry-level union wage agreement. The labour market developments in 2004 support the recommendation to clarify the *Günstigkeitsprinzip* in the *Tarifvertragsgesetz*, together with

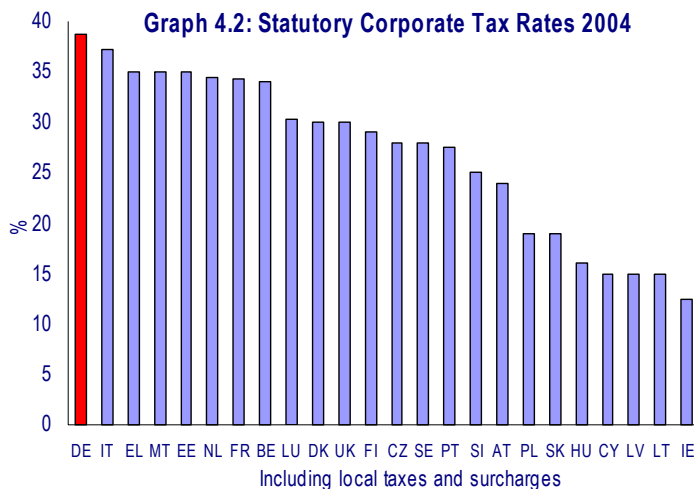
providing for opening clauses at the firm level in the *Tarifvertragsgesetz* as a complementary means to ensure that wages better reflect productivity differences. Germany, however, did not review existing legislation in this respect.

2. Productivity and business dynamism

Increase productivity through improvements in the business environment and the efficiency of the education system	Assessment
Under this challenge, Germany was requested to:	
4. encourage businesses to invest and grow by creating a more competitive environment (GL 9) and by further reducing the regulatory and administrative burden (GL 11), inter alia, by lowering the effective degree of employment protection (GL 6); and	Limited
5. carry out further reforms contributing to improved educational achievements and the elimination of persistent skill shortages (GL 13).	Limited

Measures taken to encourage businesses to invest and grow have had little effect thus far.

Business investment as a percentage of GDP declined from 18.5 per cent in 2001 to 16.3 per cent in 2003. This decline was steeper than that in other Member States, indicating it was not a pure business cycle effect. The creation of a more attractive business environment was hindered by remaining barriers to a truly integrated Internal Market. The transposition rate of Internal Market Directives in 2004 (97.5 per cent) remained below the EU target of 98.5 per cent. The Federal Government has pledged to achieve the target by the end of 2005. Although the statutory corporate tax rate has been reduced from 45% (of retained earnings)



in 1998 to 25% in 2004, nominal taxation of profits at the level of corporations remains relatively high because of the additional burden imposed by the local trade tax. However, most German companies are partnerships, subject to personal income tax with an effective tax burden that is lower than that of corporations. The government appears to be making a serious effort to broaden the tax base. Sectoral and *ad hoc*

State aids continued their slow decline. By the end of 2005, all Federal Government departments will be obliged to post their public procurement notices on a common internet portal. This obligation does not apply to state and local administrations. With the entry into force of the reformed act on unfair competition on 8 July 2004 the existing ban on special sales in the retail sector was lifted. The amended competition law aligning German law with European legislation is scheduled to come into force on 1 January 2005. In 2004, the Federal Government launched two funds to help young high-tech start-ups gain access to venture capital. In 2004, sixteen out of the 74 projects foreseen in the Government initiative to reduce bureaucracy and over-regulation were successfully implemented. In 2004, Germany relaxed the dismissal regulation to its pre-1998 state, notably by exempting small enterprises of at most 10 employees from the dismissal protection law for newly hired persons, and by

streamlining the criteria for lay-offs for operational reasons. A high-level commission to review the constitutional allocation of powers between the different levels of government (*Föderalismuskommission*) was set up in 2003, but terminated its work at the end of 2004 without having reached a final agreement.

Only 10 per cent of German schools offer all-day education.

In the summer of 2004 the Federal Government and the largest business associations launched a national agreement for training and promoting young skilled workers in Germany, with both sides pledging to increase the number of training places on offer over the next three years. Occupational profiles for vocational training are continuously being updated, especially in light of the need of SMEs, and new vocations are created primarily in order to better take into account the individual demands and skills of school leavers. In 2002/2003 only 9.6% of German schools offered all-day education, which may be considered as a tool to improve the educational attainments of students and to diminish the negative correlation between social background and scholastic success. As a result of a € 4 billion grant from the Federal Government around 3,000 schools more did so in 2004. The Länder set up a joint institute to work on education standards. However, the suggestion from the federal government to reconsider the current education system based on early selection has met resistance at the state level. The federal government is resisting attempts by the Länder to introduce tuition fees that are aimed at limiting the duration of tertiary education. A proposal to create assistant professorships without ‘Habilitation’ (a specific qualification for university lecturers) has been presented to the federal parliament, in order to improve and accelerate the process of qualification and training of young researchers.

3. Public finances

	Assessment
Reduce rapidly the general government deficit to below 3 per cent of GDP and keep government finances on a steady consolidation path	
Under this challenge, Germany was requested to:	
6. achieve an annual reduction in the cyclically-adjusted deficit of 0.6 per cent of GDP in 2004 and of at least 0.5 per cent of GDP or a larger amount in 2005 so as to ensure that the general government deficit is brought below 3 per cent of GDP in 2005 (GL 1);	Limited
7. should the recovery in economic activity be stronger than currently expected, allocate any higher-than-expected revenues to deficit reduction and accelerate the reduction in the cyclically-adjusted deficit; and	n.a.
7bis. ensure that the budgetary consolidation continues in the years after 2005, namely through a steady reduction in the cyclically-adjusted budgetary deficit by at least 0.5 percentage points of GDP per year or more if necessary to achieve the medium term position of government finances close to balance or in surplus and bring back the debt ratio to a declining path (GL 1).	Insufficient

Expenditure restraint, but shortfalls in tax revenue

With additional budgetary measures adopted in late 2004, Germany can be expected to bring its general government deficit just below 3% of GDP in 2005. Augmenting its Autumn 2004 forecast by these measures, the Commission projects the deficit at 2.9% in 2005. Although the cyclically-adjusted deficit is estimated to have widened by 0.4% of GDP in 2004, with the additional measures an improvement by 1% of GDP in 2005 and by 0.3% of GDP in 2006 are projected. Although real GDP growth in 2004 at 1.9 per cent turned out stronger

than expected by the Commission and by the German authorities in spring 2004, public revenues nevertheless fell short of expectations.

The reason for the revenue shortfall lies to a large extent in the composition of GDP growth, which was driven almost exclusively by buoyant export demand, resulting in value added taxes and excise duties below expectations. Stagnating real wages and uncertainty about the effects of the structural reform process, but also restraint on the part of corporate investors, dampened domestic demand. Yet, the budgetary authorities managed to keep expenditure under firm control. In nominal terms, public spending stagnated in 2004, including the additional measures, is projected to do so again in 2005. The weakening of the cyclically-adjusted balance in 2004 mechanically reflects the tax-unfavourable growth composition (but also discretionary tax cuts); this effect is expected to reverse with domestic demand picking up in 2005 and 2006, which should enable the cyclically-adjusted balance to improve in these years. However, none of the additional measures taken in late 2004 contribute to long-term sustainability. Indeed, some of the expenditure relief in the short-run will lead to higher expenditure in the future. According to the 2004 update of the stability programme, a position of government finances close to balance or in surplus is not achieved in the medium-term.

4. Long-term sustainability of public finances

Secure the long-term viability of pension and health-care systems	Assessment
Under this challenge, Germany was requested to:	
8. promote the take-up of supplementary pension schemes and strengthen incentives for later retirement (GL 16); and	In progress
9. increase the efficiency in the health care sector by introducing economic incentives for health care providers and recipients.	Limited

Pensions: striving for sustainability, but incentives yet too weak

Germany continued to overhaul its pension system with three laws in 2004. The “law on sustainable funding of the pension system” (*RV-Nachhaltigkeitsgesetz*) modifies the annual adjustment for public pensions according to the rise in gross wages through a “sustainability factor”, which takes into account the ratio of contributors to benefit recipients. Incentives for later retirement were partially strengthened. On the one hand, the earliest possible retirement age for previously unemployed persons and persons in a gradual retirement scheme (*Altersteilzeit*) will be raised gradually from 60 to 63 years from 2006 onwards. In addition, the labour market reform legislated in 2003 foresees a reduction in the maximum unemployment benefit duration of persons above 55 years of age from 32 to 18 months from 2006 on. On the other hand, the pension system still provides incentives to retire early, as the present value of retiring one year earlier is greater than the present value of the pension with one additional year of contributions (discounted by the individual time preference rate). Despite this, the discount to early retirement is actuarially fair in the sense that such behaviour does not additionally burden the contribution base. A decision on the increase in the statutory retirement age beyond 65 was postponed.

The old-age income law (*Alterseinkünftegesetz*) provides for the gradual introduction of taxation of pension benefits, coupled with tax exemption for retirement contributions. Due to the progressive income tax schedule, incentives to increase retirement saving are enhanced. In addition, the portability of occupational pensions was improved. The bureaucracy related to the financial products eligible for subsidised fully funded supplementary private pension income (*Riester-Rente*) was trimmed, but consumers should receive more guidance in the

choice of such complex financial products. A third law unified the various public pension insurers into a more efficient administration.

Health sector: efforts at cost containment and some efficiency gains

As mentioned in the 2004 Implementation Report, legislation to contain the costs in the public health care sector entered into force in January 2004. It involved cuts in the catalogue of goods and services refundable by the system, a better incentive structure to raise cost-awareness with patients and providers, and some steps to strengthen competition in the sector. In the public health system, expenses for medical treatment are usually fully settled between service providers and insurers without involvement of the patients. To mitigate disincentives, a fixed quarterly fee for ambulatory health services was introduced and patients were given the opportunity to ask for a 'virtual' bill to increase transparency. In addition, patients were offered the choice to switch to a system in which they receive the bill first and get reimbursed by the public insurer. Although the number of medical consultations was falling in 2004, the two other measures met a faint response. Without some financial participation of patients for each ambulatory treatment, incentives do not seem strong enough to review the doctor's bill.

Co-payments to medication were increased and the price regulation on prescription medication extended. Also, the remuneration of chemists was altered such as to provide incentives to sell lower priced medication of the same class. Yet, despite permitting mail-order and small chains of pharmacies, barriers to entry into the retailing of medication remain. . A newly established institute will provide producer-independent benefit analysis of medication and guidelines for treatment.

The public health system is still characterised by collective contracting of fees between insurers and service provider organisations. Although a fair amount of competition takes place between public health insurers, it is almost absent between service providers. Individual contracting has now been permitted in limited areas, but this is only a first step in the right direction. In the first three quarters of 2004, expenditure in the public health sector fell remarkably by about € 3.4 bn y-o-y (about 0.2% of GDP for the same period). A reduction in medication expenditure by over 10% provided the largest contribution, reflecting both cost-cutting measures and reduced demand due to co-payments. Expenditure on ambulatory treatment declined by 5%, reflecting the positive allocation effect of the fixed quarterly fee. The cost-cutting measures reduce the level of expenditure. However, in order to contain the growth rate of expenditure, further efficiency-enhancing measures are necessary in the medium-term, not only for patients but also for health care providers and insurers.

Table 4.1: Economic indicators for Germany

	Germany				EU-25			
	2001	2002	2003	2004	2001	2002	2003	2004
General economic background								
Real GDP growth ¹	0.8	0.1	-0.1	1.9	1.8	1.1	1.0	2.5
Inflation ²	1.9	1.3	1.0	1.7	2.5	2.1	1.9	2.2
Labour productivity growth ³	0.4	0.7	0.9	1.8	0.8	0.9	0.9	2.1
Employment growth ¹	0.4	-0.6	-1.0	0.1	1.0	0.3	0.3	0.4
Nominal wage growth ⁴	1.7	1.5	1.6	0.0	4.0	3.2	3.1	3.0
Current account ⁵	0.4	2.4	2.4	4.2	:	:	:	:
Unemployment ⁶	7.8	8.7	9.6	9.7	8.5	8.9	9.1	9.1
Public finance								
General government balance ⁵	-2.8	-3.7	-3.8	-3.9	-1.2	-2.3	-2.8	-2.8
Primary balance ⁵	0.4	-0.5	-0.7	-0.8	2.4	1.0	0.3	0.2
Cyclically-adjusted balance ⁵	-3.1	-3.5	-3.0	-3.4	:	:	:	:
Gross government debt ⁵	59.4	60.9	64.2	65.9	62.1	61.6	63.2	63.5
Employment								
Employment rate ⁷	65.8	65.4	65.1	:	62.8	62.9	63.0	:
Female employment rate ⁸	58.7	58.9	59.1	:	54.3	54.7	55.1	:
Employment rate for older workers ⁹	37.9	38.9	39.5	:	37.4	38.8	40.2	:
Long-term unemployment ¹⁰	3.8	4.1	4.7	:	3.8	3.9	4.0	:
Tax rate on low wage earners ¹¹	45.5	45.8	46.7	:	37.2	37.1	37.4	:
Unemployment trap indicator ¹²	87.9	88.4	88.8	:	78.8	78.5	78.3	:
Product market reforms								
Hourly labour productivity ¹³	102.8	103.0	103.4	:	:	:	:	:
Total trade to GDP ratio ¹⁴	34.5	34.1	34.3	:	30.1	29.2	28.7	:
Internal Market Directives ¹⁵	97.4	97.3	96.5	97.5	:	:	:	96.3
Business investment ¹⁶	18.5	16.9	16.3	:	17.9	17.2	16.8	:
Knowledge-based economy								
Total tertiary graduates ¹⁷	31.0	30.9	:	:	46.8	:	:	:
Spending on human resources ¹⁸	4.6	:	:	:	5.1	:	:	:
R&D expenditure ¹⁹	2.5	2.5	2.5	:	1.9	1.9	:	:
Expenditure on IT ²⁰	3.3	3.0	3.0	2.9	3.1	2.9	2.9	2.9

¹ Growth rate in percentage.

² Annual average rate of change in harmonised index of consumer prices in percentage.

³ Growth rate of real GDP per occupied person in percentage.

⁴ Growth rate of compensation per employee.

⁵ As a percentage of GDP.

⁶ Number of unemployed as a percentage of the labour force.

⁷ Employed persons aged 15-64 as a share of the total population of the same age group.

⁸ Employed women aged 15-64 as a share of the total female population of the same age group.

⁹ Employed persons aged 55-64 as a share of the total population of the same age group.

¹⁰ Long-term unemployed (over 12 months) as a percentage of the total active population aged 15-64.

¹¹ Income tax plus employer/employee contributions as a percentage of labour costs of a single earner at 67% of the Average Production Worker-wage, no children.

¹² Effective tax rate on labour income taking into account the combined effect of increased taxes and benefits withdrawal as an individual moves from unemployment back to work earning 67% of the Average Production Worker-wage, measured at the first month of unemployment (after any 'waiting period' if applicable).

¹³ GDP per hour worked in PPS, EU-15=100.

¹⁴ Percentage, average value of imports and exports of goods and services divided by GDP, multiplied by 100. For DE, ES, FR, IT, PL and the UK the value for EU-25 is the total for the large Member States, for all the other states the value for EU-25 is the total for the small Member States.

¹⁵ Percentage implemented in November 2004.

¹⁶ Gross fixed capital formation by the private sector as a percentage of GDP.

¹⁷ Total tertiary graduates (ISCED 5-6) per 1000 of population aged 20-29.

¹⁸ Public expenditure on education as a percentage of GDP.

¹⁹ GERD Gross domestic expenditure on R&D as a percentage of GDP.

²⁰ Expenditure on information technology as a percentage of GDP.

Source: Commission services (incl. Eurostat, structural indicators)

The data for 'general economic background' and 'public finance' are taken from the Commission's Autumn 2004 Economic Forecasts.

5. ESTONIA

Introduction

Economic activity gained further momentum in 2004. GDP growth of nearly 6 per cent was underpinned by robust domestic demand, a positive contribution from net exports and a strong fiscal stimulus stemming from the unwinding of the high 2003 fiscal surplus. Developments were also marked by various EU accession effects. Consumer price inflation accelerated, to an annual rate of over 3 per cent. The higher inflation led to a squeeze in real wage gains, which over the medium term are expected to remain in line with productivity increases. Labour market conditions continued to improve in 2004, as reflected by moderate employment growth, rising labour supply and a further decline in unemployment, a development which is expected to broadly continue over the medium term. A legal package addressing the structural problems in the labour market was adopted by the government in late 2004. The general government surplus, which had widened to 3.1 per cent of GDP in 2003, was reduced in 2004 to an estimated 1 per cent of GDP (according to the latest convergence programme). Public finances are likely to remain in balance or surplus over the foreseeable future. The correction of the external balance has been delayed, with the current account deficit remaining virtually unchanged around 13 per cent of GDP in 2004. Estonia's growth rates of labour productivity and GDP per capita are set to remain amongst the highest in the EU. Estonia offers a good business climate and measures to increase the currently low level of competition in network industries have been taken. The level of R&D remains low, and the pending changes to the education system will affect the country's competitiveness only over the medium term. A detailed assessment of recent developments in addressing Estonia's key policy challenges is presented in the following sections.

1. Current account deficit

Address the sizeable current account deficit, to which an appropriate fiscal policy stance should contribute

Under this challenge, Estonia was requested to:

1. implement a fiscal policy that is in line with the decisions to be taken by the Council in the context of the forthcoming budgetary surveillance exercise (GL 1), and which is consistent with the objective of avoiding pro-cyclical policies that may exacerbate the external imbalance and promotes reduction of the sizeable gap between domestic savings and investment (GL 2).

Correction of the current account deficit delayed beyond 2004...

The high current account deficit remains the main economic imbalance in Estonia. While the trade balance improved somewhat in 2004, the major contributor to the deficit was the increasingly negative income balance, including huge inter-bank-operations between the dominant Scandinavian banks and their Estonian branches. Overall, a reduction of the deficit starting already in 2004, as envisaged in the Estonian convergence programme of May 2004, has not materialised, with the external deficit remaining around 13 per cent of GDP. Moreover, a reduction of public savings, deriving from a reduction of the budget surplus from 3.1 per cent of GDP in 2003 to, according to the latest official forecast, an estimated 1 per cent of GDP in 2004 has not sufficiently supported the correction of the external imbalance. With a view to the high level of the current account deficit, a more gradual unwinding of the comfortable budgetary surplus would have been advisable. In addition, private savings in 2004 have not recovered as quickly as projected, with rising company profits countervailed by a decrease in household saving. As pointed out in the Council Opinion on the Estonian convergence programme, the defacto fiscal expansion might prove untimely in view of accelerating activity in 2004, even if it is difficult to determine the

country's position in the business cycle. For 2005, the authorities plan a balanced budget implying further, albeit much lower, fiscal easing. The current account deficit is expected to come down to below 12 per cent of GDP in 2005, according to the Commission forecast, thanks to an improvement in the trade balance.

...whereby external imbalance should be put into perspective

The reasons for the external deficit are to a large degree 'normal' transitional effects in a rapidly catching up economy that is expanding its productive potential. While gross external debt has increased to sizeable levels, net debt remains relatively low. Foreign liabilities are mostly denominated in euro, which mitigates the exchange rate risk, given the stable currency board maintained within ERM II. A considerable share of the current account deficit is financed by FDI, which in turn include a large amount of reinvested earnings. A high level of public sector reserves, to the tune of over 10 per cent of GDP, which was set aside over the past few years from budget surpluses can also be considered as a stabilising – and confidence-enhancing – factors. While such considerations on the external sustainability put the current account deficit into perspective, the further trend of both public and private net saving as well as developments in competitiveness and FDI need to be closely watched.

2. Labour market

Address the structural problems in the labour market

Under this challenge, Estonia was requested to:

2. adopt policies with particular emphasis on re-integrating the long-term unemployed, particularly in regions worst hit by the restructuring of the economy, by promoting vocational training and life-long learning, and by setting up an effective institutional framework that is supporting job creation (GL 4, 6 and 8); and
3. encourage social partners to ensure that wage developments - including changes to the minimum wage legislation - do not hinder employment growth, and hold up the recovery in the labour market (GL 3 and 5).

Important labour market reforms are under way...

Labour market conditions continued to improve in 2004. The unemployment rate, according to the harmonised EU definition, declined by 0.4 percentage points to 9.7 per cent of the labour force, while employment steadily increased, and is set to rise further in 2005. Also, regional disparities of unemployment rates have started to diminish. Despite these overall positive developments, a number of specific problems of a predominantly structural nature prevail to this date, many of which date back to the transition process from plan to market economy. An active labour market policy is designed to bring problem groups of the work force back into jobs. To that end, a legal package has been adopted by the government in autumn 2004. The authorities plan to replace unemployment benefits and subsistence allowance for people of working age and capacity with a 'jobseeker's allowance', aiming at increasing the incentive for the long-term unemployed to actively look for jobs. The draft law foresees both reforms to the vocational training system, through gearing training better towards skills in high demand in order to increase employment ratios, and a reduction of taxes and social charges on labour, thereby increasing the incentive to take on low-wage jobs. EU funds will be used to implement some of these measures.

...while wage increases have moderated

Wage pressures in Estonia moderated in 2004, following an overshooting of real wages over productivity gains in 2003. The fairly flexible labour market is characterized by a small role of collective wage bargaining. Mostly, wages are set at the enterprise level, and tend to react swiftly to changes in the economic environment. The minimum wage, however, is set at national level. In 2004, it stood at 32 per cent of the average national wage, and thus was the lowest among New Member States. A medium-term rule for the path of minimum wage increases was agreed last year by the Tripartite Social Partner Council, stipulating an annual increase of 1.5 percentage points as related to the average national wage over the period 2005-2008. Apart from the minimum wage, only a limited number of sectors like central government, transport, education and health care is subject to central wage bargaining. In the context of a major income tax cut, taking effect in three steps in 2005, 2006 and 2007, non-wage labour costs will be reduced by a total of 6 per cent. In addition, a stepwise increase to the threshold for income tax exemption which started already in 2004 and will continue through to 2007 is neutralising the bracket creep effect. Both measures have a net-earnings-enhancing effect, and thus take pressure from gross wage settlements. In the Commission's Autumn 2004 Economic Forecasts it is assumed that wage moderation will continue in 2005. In an environment of stable prices, with CPI inflation around 2.5-3 per cent throughout the forecast period, along with income tax cuts, real wages per head are expected to advance below productivity increases.

3. Productivity and business dynamism

Improve conditions for increasing productivity

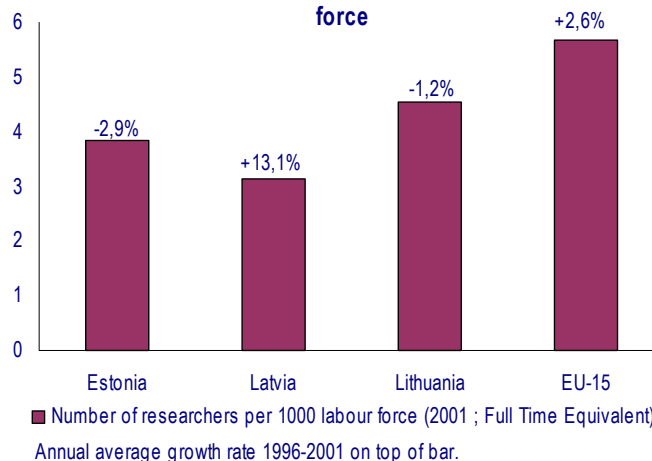
Under this challenge, Estonia was requested to:

4. improve the efficiency and quality of the education system and vocational training in order to reduce the mismatch on the labour market (GL 13); and
5. implement the R&D strategy approved in 2001 and, in particular, promote the stronger involvement of the business sector in R&D spending (GL 13).

Modernisation of vocational education is continuing...

Over recent years, Estonia has pursued a strategy of modernisation of its vocational education policy, notably to bring down the very high 18 per cent drop-out rate during the first year of secondary school education. This policy also aims at increasing education's responsiveness to labour market needs. In 2004, a new vocational education development plan for 2005-2008 has been elaborated and Estonia has prepared for the future use of EU structural funds to meet this goal. Current and future actions include the assessment of businesses' needs and demand for vocational training, as well as maintaining the school network but few measures have been taken to improve the education system per se.

Graph 5.1: Number of researchers per 1000 labour force



... and efforts pursued increase R&D, albeit slowly.

At around 0.8 per cent, the ratio of R&D expenditure to GDP has slightly increased but still remains far below the EU-average. In addition, the share of R&D financed by the industry is low at just 30 per cent and the number of researchers per 1000 labour force has even decreased over the recent period. The limited scope of the local market, the low number of large companies and the lack of cooperation between research and businesses contribute to a low level of innovation, as reflected in a low level of patenting activity. Making use of future EU structural funds, the Estonian National Development Plan 2004-2006 focuses on the pooling of research activities, the increase of the financing of R&D and innovation by businesses, developing cooperation between researchers and entrepreneurs, and boosting awareness and knowledge of innovation.

4. Productivity and business dynamism

Develop effective competition in network industries

Under this challenge, Estonia was requested to:

6. proceed with the liberalisation of the electricity market, strengthen the independence of the regulator and ensure effective competition in telecommunications (GL 9).

Reforms to increase effective competition in network industries progress at slow pace.

In the EU accession treaty, Estonia has been granted a transitional period for the opening up of its electricity market. According to the agreement, 35 per cent of the electricity market should be opened to competition by the end of 2008, and full opening should follow by the end of 2012. The current degree of openness stands at around 10 per cent for electricity whilst the gas market for non-household users has been made contestable in line with EU directives, corresponding to a 95 per cent degree of market opening. Despite the transition period, legal unbundling of the electricity Transport System Operator shall occur in 2005, and plans are developed to connect the Estonian electricity network to the Finnish one. Following liberalisation in 2003, the telecommunications market has experienced rapid expansion. The introduction of number portability for fixed lines in 2004 and for mobile phones in 2005 should further increase competition in a market where the incumbent is steadily losing market shares. No new measures have been announced to strengthen the independence of the regulators.

Table 5.1: Economic indicators for Estonia

	Estonia				EU-25			
	2001	2002	2003	2004	2001	2002	2003	2004
General economic background								
Real GDP growth ¹	6.4	7.2	5.1	5.9	1.8	1.1	1.0	2.5
Inflation ²	5.6	3.6	1.4	3.4	2.5	2.1	1.9	2.2
Labour productivity growth ³	5.6	5.6	4.3	5.6	0.8	0.9	0.9	2.1
Employment growth ¹	0.8	1.5	0.8	0.3	1.0	0.3	0.3	0.4
Nominal wage growth ⁴	7.7	10.2	8.9	8.6	4.0	3.2	3.1	3.0
Current account ⁵	-5.6	-10.2	-13.2	-13.0	:	:	:	:
Unemployment ⁶	11.8	9.5	10.1	9.7	8.5	8.9	9.1	9.1
Public finance								
General government balance ⁵	0.3	1.4	3.1	0.5	-1.2	-2.3	-2.8	-2.8
Primary balance ⁵	0.5	1.7	3.3	0.8	2.4	1.0	0.3	0.2
Cyclically-adjusted balance ⁵	:	:	:	:	:	:	:	:
Gross government debt ⁵	4.4	5.3	5.3	4.8	62.1	61.6	63.2	63.5
Employment								
Employment rate ⁷	61	62	62.9	:	62.8	62.9	63.0	:
Female employment rate ⁸	57.4	57.9	59	:	54.3	54.7	55.1	:
Employment rate for older workers ⁹	48.5	51.6	52.3	:	37.4	38.8	40.2	:
Long-term unemployment ¹⁰	5.7	5	4.6	:	3.8	3.9	4.0	:
Tax rate on low wage earners ¹¹	37.4	37.4	:	:	37.2	37.1	37.4	:
Unemployment trap indicator ¹²	:	:	:	:	78.8	78.5	78.3	:
Product market reforms								
Hourly labour productivity ¹³	32.9	33.7	:	:	:	:	:	:
Total trade to GDP ratio ¹⁴	85.6	77.6	79.0	:	:	58.8	57.2	:
Internal Market Directives ¹⁵	:	:	:	94.5	:	:	:	96.3
Business investment ¹⁶	22.9	24.0	25.0	:	17.9	17.2	16.8	:
Knowledge-based economy								
Total tertiary graduates ¹⁷	40.1	40.9	:	:	46.8	:	:	:
Spending on human resources ¹⁸	5.5	:	:	:	5.1	:	:	:
R&D expenditure ¹⁹	0.7	0.8	0.8	:	1.9	1.9	:	:
Expenditure on IT ²⁰	2.7	2.7	2.7	2.6	3.1	2.9	2.9	2.9

¹ Growth rate in percentage.

² Annual average rate of change in harmonised index of consumer prices in percentage.

³ Growth rate of real GDP per occupied person in percentage.

⁴ Growth rate of compensation per employee.

⁵ As a percentage of GDP.

⁶ Number of unemployed as a percentage of the labour force.

⁷ Employed persons aged 15-64 as a share of the total population of the same age group.

⁸ Employed women aged 15-64 as a share of the total female population of the same age group.

⁹ Employed persons aged 55-64 as a share of the total population of the same age group.

¹⁰ Long-term unemployed (over 12 months) as a percentage of the total active population aged 15-64.

¹¹ Income tax plus employer/employee contributions as a percentage of labour costs of a single earner at 67% of the Average Production Worker-wage, no children.

¹² Effective tax rate on labour income taking into account the combined effect of increased taxes and benefits withdrawal as an individual moves from unemployment back to work earning 67% of the Average Production Worker-wage, measured at the first month of unemployment (after any 'waiting period' if applicable).

¹³ GDP per hour worked in PPS, EU-15=100.

¹⁴ Percentage, average value of imports and exports of goods and services divided by GDP, multiplied by 100. For DE, ES, FR, IT, PL and the UK the value for EU-25 is the total for the large Member States, for all the other states the value for EU-25 is the total for the small Member States.

¹⁵ Percentage implemented in November 2004.

¹⁶ Gross fixed capital formation by the private sector as a percentage of GDP.

¹⁷ Total tertiary graduates (ISCED 5-6) per 1000 of population aged 20-29.

¹⁸ Public expenditure on education as a percentage of GDP.

¹⁹ GERD Gross domestic expenditure on R&D as a percentage of GDP.

²⁰ Expenditure on information technology as a percentage of GDP.

Source: Commission services (incl. Eurostat, structural indicators)

The data for 'general economic background' and 'public finance' are taken from the Commission's Autumn 2004 Economic Forecasts.

6. GREECE

Introduction

Economic activity in Greece remained strong in 2004 benefiting from a series of factors some of which were related to the Olympic Games. Owing to the sharp acceleration of exports of services, the negative contribution of the external sector narrowed in 2004. However, despite the temporarily favourable domestic conditions the Greek economy continued to suffer from its chronic structural problems notably the external imbalance pointing to a weak international competitiveness and the recently increasing fiscal imbalances that reveal a lack of decisiveness in implementing the necessary measures to control and streamline government spending. The control on a more permanent basis of fiscal imbalances is of primary importance as Greece has made little progress in reducing the still high government debt and deficits. Although the situation in the labour markets has improved lately the implementation of measures aiming at rendering employment conditions more flexible resulted to slow progress. Some signs of improvement with respect to the employment participation rate, and long-run and youth unemployment have recently become evident. Conversely, the gap between the male and female rate of participation and unemployment has hardly narrowed. Greek hourly labour productivity growth slowed down in recent years and remains the second lowest in the EU-15. This is partly due to low levels of investment in R&D, and the still low -albeit fast growing- level of ICT diffusion. Limited competition in certain network industries and a lack of business dynamism, due to complex regulation and taxation system, can also be part of the explanation. A detailed analysis of recent developments in addressing Greece's key policy challenges is presented in the following sections.

1. Long-term sustainability of public finances

Ensure the long-term sustainability of public finances in the face of population ageing, in particular in view of the high government debt ratio	Assessment
Under this challenge, Greece was requested to:	
1. ensure that the government debt ratio is kept on a sustained declining trend at a satisfactory pace by maintaining high primary surpluses (GL 15);	Insufficient
2. take appropriate measures in response to the possible existence of an excessive deficit; move towards achieving 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 per cent of GDP per year, including through effective control of government current primary spending (GL 1);	Insufficient
3. use public resources more effectively with the aim of improving labour productivity and enhancing working capacity of the unemployed (GL 14); and	Insufficient
4. continue reforms of the social security system, and in particular the pension system (GL 16), in order to avoid budgetary strains in the future due to the problem of the ageing population.	Insufficient
Bearing in mind the three-year period available for implementation, the degree of implementation since 2003 is indicated as: "Complete" for (practically) complete; "In progress" where progress is well advanced; "Limited" where the recommendation is only partially addressed and "Insufficient" where no substantial measures going in the right direction have been taken.	

Measures have not been taken to reduce the debt ratio at a satisfactory pace

The government debt ratio in Greece is according to the latest EDP notification the highest in the EU. After the corrections in the treatment of some financial operations requested by Eurostat, the EDP notification of September 2004 indicated that the debt figures have been revised upwards by 7 to 9 percentage points of GDP over the period of notification. In 2003 the debt ratio decreased temporarily by 2.6 percentage points and reached 109.9 per cent of GDP. Despite strong economic growth the debt ratio is estimated to have increased again in 2004 by 2.3 percentage points, implying that the Greek government did not succeed in reducing the debt ratio at a satisfactory pace. The general government primary surplus, which has kept declining over the past five years, reached its lowest level in 2004. As the primary surplus is expected to improve in 2005 according to the Commission services 2004 autumn forecasts, the debt ratio is projected to decline slightly, by 0.3 percentage points. According to the 2005 Draft Budget, in 2005 public debt will reach 109.5 per cent of GDP (versus 112.1 per cent in 2004).

Still far away from the budgetary position of close to balance or in surplus

The Commission activated the excessive deficit procedure (EDP) for Greece on 19 May 2004. At that time, the expected general government deficit for 2004 was 3.2 per cent of GDP, unchanged compared to 2003. The EDP notification of September 2004, as validated by Eurostat, indicated that Greece has been in excessive deficit since 2000. After reaching 4.6 per cent of GDP in 2003, the general government deficit is estimated by the Commission services to have increased further in 2004 to 5.5 per cent of GDP. The increase in the deficit between 2003 and 2004 suggests that the budgetary situation in Greece has significantly worsened compared with what had been expected at the time of adopting the EDP report. Also, no effective action has been taken to correct the excessive deficit, in response to the July 2004 Council recommendation for the correction of the excessive deficit. The considerable widening of the deficit compared to 2003 in spite of a positive output gap reflects the pro-cyclical, expansionary nature of Greek fiscal policies. In cyclically-adjusted terms, Greece moved further away from a budgetary position of close to balance or in surplus. According to the Commission services 2004 autumn forecasts, the deficit for 2005 will narrow to 3.6 per cent of GDP. Also the cyclically-adjusted budget balance is projected to improve by 1.7 per cent of GDP in 2005 as the government is expected to control - but possibly insufficiently - the current primary spending in its effort to reduce the deficit to below the 3 per cent of GDP reference value.

Labour productivity decelerated and measures to reduce unemployment have not yet delivered the expected results.

Labour productivity growth slowed down in 2003 and in 2004 but is likely to pick up slightly in 2005. A series of measures aimed at increasing the incentive to work as well as measures aimed at improving the qualification of the unemployed are being implemented with the financial support of government agencies. In particular, a legislation which was enacted in 2004 to replace the unemployment subsidies with employment subsidies provides incentives to work for women, young people and the elderly. Also legislation was enacted in 2004 to permit the state, the local administrations and institutions of public law to employ certain categories of workers, namely, unemployed women, persons with more than three children, long-term unemployed, with fixed term contracts. The Ministry of Employment and Social Protection promoted the direct connection of vocational training activities with employment while the Public Employment Services (OAED), which is the basic implementation body of the active employment policies, has been upgraded and reformed. However, there is yet no clear evidence as to the effectiveness of these measures. The youth unemployment ratio is still higher than the corresponding European average while the gap between men and women is still significant in the unemployment rate.

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

The implementation of legislation enacted in 2002 lies at the heart of efforts to reform the pension system, with an emphasis on the introduction of new instruments that add credibility and flexibility to the system. In this legislation, however the government has not sufficiently taken into account the current trends in public finances and especially the high level of government debt. As the budgetary costs from population ageing are expected to significantly rise in the future, the sustainability of the Greek public finances will be at risk if no structural measures are taken. According to legislation recently enacted, provision has been made for the transfer of social security rights when moving from one fund to another and incentives have been provided for the prolongation of working life beyond the statutory limit of 35 years. Distinguishing auxiliary from primary pensions, through the creation of separate auxiliary Funds and the consolidation of various funds remains a major priority and specific steps have been taken in this direction. New measures were adopted in 2004 with the aim of amending various aspects of existing legislation, particularly as far as persons with disabilities, farmers, professionals and civil servants are concerned. Also, considerable effort is being made to combat the evasion of contribution, among others through the establishment of a special force which monitors health-care payments made by social insurance institutions. There is yet no clear evidence as to the effectiveness of these new measures.

2. Productivity and business dynamism

Increase the low level of productivity, which is associated with problems in the functioning of the labour and product markets, low investment in human capital, and the late development of the knowledge-based society	Assessment
Under this challenge, Greece was requested to:	
5. step up efforts to increase the availability of skilled human capital, and continue to promote business involvement in R&D and innovation, and improve ICT diffusion (GL 13);	In progress
6. enhance particularly competition in the energy sectors (GL 9); and	Limited
7. continue to simplify the business and taxation environment and raise the transposition rate of internal market directives (GLs 9 and 11).	Limited

Initiatives to encourage the transition towards a knowledge-based society launched in 2003 have been pursued.

Initiatives were launched in 2003 to improve the availability of skilled human capital and to promote R&D, innovation and ICT diffusion have been pursued. First, further actions promoting the development of information technology in schooling and professional training were taken in 2004. Second, the links between universities and enterprises were further strengthened through initiatives supporting the establishment of spin-off-firms. For example 25 co-operations between firms and R&D centres, universities and training institutions were partially funded by the Greek government in 2004. Third, within the framework of the operational programme for the information society, the implementation of actions aimed at promoting the use of ICT within business communities (the actions “Go electronically” and “e-business development”) and by the public sector has started.

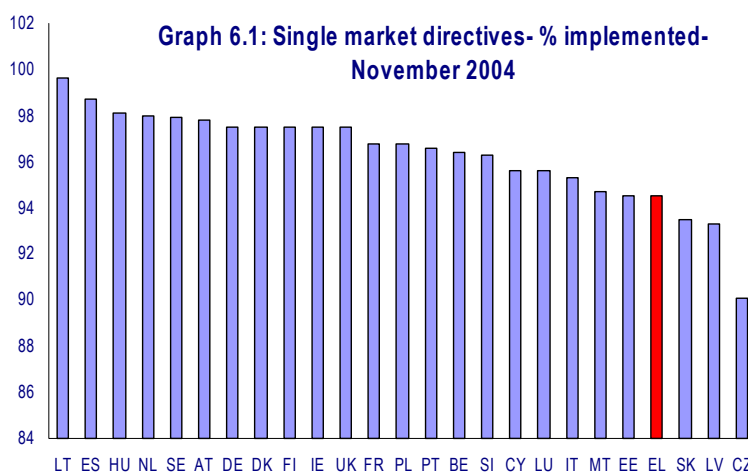
Steps in the right direction are being taken, but effective competition in the electricity market is not yet secured.

Apart from interconnections already in place, with Albania, Bulgaria, FYROM and Italy, the interconnection between the Greek and Turkish gas networks is expected to be in operation

by the end of 2006. In addition, a feasibility study on the interconnection with Italy is expected to be delivered in December 2004. In the electricity sector several licences to independent power generators have been granted. Greece is currently finalising the amendment of its legislation to fully transpose the EU energy directives. However, the infringement procedure relating to the unbundling of the incumbent company is still pending and the Commission decided to refer the case to the European Court of Justice.

Efforts have been made to simplify the business and taxation environment but the transposition rate of internal market directives has decreased.

New legislation to reduce bureaucratic and legal obstacles to setting up a new company has been prepared. Moreover, measures to increase the efficiency of the public administration have been taken. For example, interconnections between various points within the public administration have been created and new “one stop shops” for citizens have been set up. The Government has launched a new tax reform aimed at both a reduction of corporate taxes and a simplification of the tax audit procedure. Finally Greece’s transposition rate of internal market directives has decreased from 96.9 per cent to 94.5 per cent, and is still amongst the worst in the EU15.



3. Labour market

Reduce the high rate of structural unemployment, and increase employment rates, particularly for women	Assessment
Under this challenge, Greece was requested to:	
8. improve work incentives, particularly by reducing non-wage costs and improving transferability of pension rights, in order to encourage increased employment in the formal sector, including part-time work (GL 4 and 16);	Limited
9. promote changes to the wage bargaining process to ensure that wages reflect productivity differentials (GL 5); and	Insufficient
10. implement the labour reform package to improve the balance between flexibility and security by ensuring effective implementation of reforms aiming to modernise work organisation and by reviewing unduly restrictive labour market regulations (GL 6).	Limited

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

Despite some improvement and efforts undertaken in the past to promote part-time work, its share has stagnated at low levels. The implementation of legislation enacted in 2004 which extend part-time employment in both the public and the private sector, has not yet delivered the expected results. Incentives in the form of subsidising social security contributions for

certain categories of the labour force and for specific sectors have been introduced since 2002. The government in its effort to promote active employment policies announced in 2004 plans of subsidised employment. So far, the reaction of the private sector has not been very encouraging. Furthermore, there seems to be no focus on the reduction of non-wage costs. As mentioned above, the government has introduced changes to the 2002 legislation in order to ensure social security rights when moving from one fund to another.

Social dialogue is put forward but wage bargaining is hardly modified.

Enhancing the social dialogue has been among the priorities of the former and new government with wage bargaining being among the core issues. The private sector is bound by 2-year wage agreements negotiated at the national level, setting the minimum wage for general and sectoral agreements. The benchmark wage in the private sector is linked to the announced income policy in the public sector and to inflation prospects rather than to productivity differentials. The previous agreement, signed in 2002, secured social peace until the end of 2003, while limiting the impact of higher than expected inflation on wage formation. A new two year wage agreement was concluded on 13 May 2004. It implies an increase in the minimum wages above the expected inflation and productivity in 2004 and 2005.

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

The restructuring of public and private employment services has not yet sufficiently addressed both employment and unemployment issues, given the still high barriers to entry and the strong rigidities in the Greek labour market. Nevertheless, many efforts have been made recently to improve services to the unemployed. In particular, as mentioned above, the Public Employment Service (OAED) has been upgraded. 71 Job Centres (KPA) have been created employing 471 labour advisers, while the statistical surveillance system of OAED is being upgraded. A centralized information system of PAEP S.A., a subsidiary firm of OAED, was created to monitor the personalised approach of the unemployed. Also, in conjunction with the Job Centres, Private Agencies of Work Advisers (IGSE) have started operating. Temporary Employment Companies (EPA) are expanding and by now 10 EPAs have been founded while 9,040 persons have already benefited from them.

Table 6.1: Economic indicators for Greece

	Greece				EU-25			
	2001	2002	2003	2004	2001	2002	2003	2004
General economic background								
Real GDP growth ¹	4.3	3.6	4.5	3.8	1.8	1.1	1.0	2.5
Inflation ²	3.7	3.9	3.4	3.0	2.5	2.1	1.9	2.2
Labour productivity growth ³	4.6	3.6	3.1	2.0	0.8	0.9	0.9	2.1
Employment growth ¹	-0.3	0.1	1.4	1.8	1.0	0.3	0.3	0.4
Nominal wage growth ⁴	5.2	9.2	4.0	6.5	4.0	3.2	3.1	3.0
Current account ⁵	-7.1	-7.7	-8.3	-7.5	:	:	:	:
Unemployment ⁶	10.4	10.0	9.3	8.5	8.5	8.9	9.1	9.1
Public finance								
General government balance ⁵	-3.7	-3.7	-4.6	-5.5	-1.2	-2.3	-2.8	-2.8
Primary balance ⁵	3.6	2.6	1.2	0.0	2.4	1.0	0.3	0.2
Cyclically-adjusted balance ⁵	-4.3	-3.8	-5.1	-6.1	:	:	:	:
Gross government debt ⁵	114.7	112.5	109.9	112.2	62.1	61.6	63.2	63.5
Employment								
Employment rate ⁷	55.4	56.7	57.8	:	62.8	62.9	63.0	:
Female employment rate ⁸	40.9	42.5	43.8	:	54.3	54.7	55.1	:
Employment rate for older workers ⁹	38	39.7	42.1	:	37.4	38.8	40.2	:
Long-term unemployment ¹⁰	5.4	5.1	5.1	:	3.8	3.9	4.0	:
Tax rate on low wage earners ¹¹	34.3	34.3	34.3	:	37.2	37.1	37.4	:
Unemployment trap indicator ¹²	69	70	76.7	:	78.8	78.5	78.3	:
Product market reforms								
Hourly labour productivity ¹³	68.6	72.1	73.7	:	:	:	:	:
Total trade to GDP ratio ¹⁴	30.3	26.5	25.0	:	:	58.8	57.2	:
Internal Market Directives ¹⁵	97.0	96.7	96.9	94.5	:	:	:	96.3
Business investment ¹⁶	19.9	20.2	21.8	:	17.9	17.2	16.8	:
Knowledge-based economy								
Total tertiary graduates ¹⁷	:	:	:	:	46.8	:	:	:
Spending on human resources ¹⁸	3.9	4.0	:	:	5.1	:	:	:
R&D expenditure ¹⁹	0.6	:	:	:	1.9	1.9	:	:
Expenditure on IT ²⁰	1.4	1.3	1.2	1.2	3.1	2.9	2.9	2.9

¹ Growth rate in percentage.

² Annual average rate of change in harmonised index of consumer prices in percentage.

³ Growth rate of real GDP per occupied person in percentage.

⁴ Growth rate of compensation per employee.

⁵ As a percentage of GDP.

⁶ Number of unemployed as a percentage of the labour force.

⁷ Employed persons aged 15-64 as a share of the total population of the same age group.

⁸ Employed women aged 15-64 as a share of the total female population of the same age group.

⁹ Employed persons aged 55-64 as a share of the total population of the same age group.

¹⁰ Long-term unemployed (over 12 months) as a percentage of the total active population aged 15-64.

¹¹ Income tax plus employer/employee contributions as a percentage of labour costs of a single earner at 67% of the Average Production Worker-wage, no children.

¹² Effective tax rate on labour income taking into account the combined effect of increased taxes and benefits withdrawal as an individual moves from unemployment back to work earning 67% of the Average Production Worker-wage, measured at the first month of unemployment (after any 'waiting period' if applicable).

¹³ GDP per hour worked in PPS, EU-15=100.

¹⁴ Percentage, average value of imports and exports of goods and services divided by GDP, multiplied by 100. For DE, ES, FR, IT, PL and the UK the value for EU-25 is the total for the large Member States, for all the other states the value for EU-25 is the total for the small Member States.

¹⁵ Percentage implemented in November 2004

¹⁶ Gross fixed capital formation by the private sector as a percentage of GDP.

¹⁷ Total tertiary graduates (ISCED 5-6) per 1000 of population aged 20-29.

¹⁸ Public expenditure on education as a percentage of GDP.

¹⁹ GERD gross domestic expenditure on R&D as a percentage of GDP.

²⁰ Expenditure on information technology as a percentage of GDP.

Source: Commission services (incl. Eurostat, structural indicators)

The data for 'general economic background' and 'public finance' are taken from the Commission's Autumn 2004 Economic Forecasts.

7. SPAIN

Introduction

Although still recording a positive growth differential with respect to the euro area, the gap has narrowed significantly in 2004, mainly due to the recent recovery in the euro area, as the Spanish economy continues to register growth rates above 2.5 per cent. Growth continues to be mainly driven by relatively buoyant domestic demand, notably private consumption, investment in dwellings and, more recently, investment in equipment, whereas the external sector's drag on GDP growth widened. Behind the resilience of domestic demand are supportive monetary conditions coupled with a prudent fiscal stance and rapid employment growth, which has largely benefited from ongoing wage moderation as well as high net immigration. In spite of relatively moderated growth, Spain was successful in keeping fiscal consolidation on course and achieved an unprecedented surplus position in 2003. The budget for the general government sector in 2004 is now expected to turn to a deficit of 0.6 per cent of GDP. Rather than representing a deterioration of the budgetary situation, this deficit is more the result of some one-off measures and statistical reclassifications adopted by the new government that do not involve revisions for past years. Bearing in mind that the period covered by this assessment encompasses the end of a legislature and the subsequent change in government, no key additional measures to those implemented in 2003 have been adopted to address Spain's key challenges as regards the pension system and the labour market. The new government intends to maintain the main policy guidelines followed over the last years and has continued to implement the initiatives that have already been introduced aiming at ensuring effective levels of competition in numerous sectors and enhancing the economy's capacity to innovate. Nevertheless, it is too premature to assess the impact of the ongoing and announced future measures on the performance of the hourly labour productivity. A "Unit to Boost Productivity" was created by the government in 2004 to propose further actions to help the economy to meet this challenge. A detailed assessment of recent developments in addressing Spain's key policy challenges is presented in the following sections.

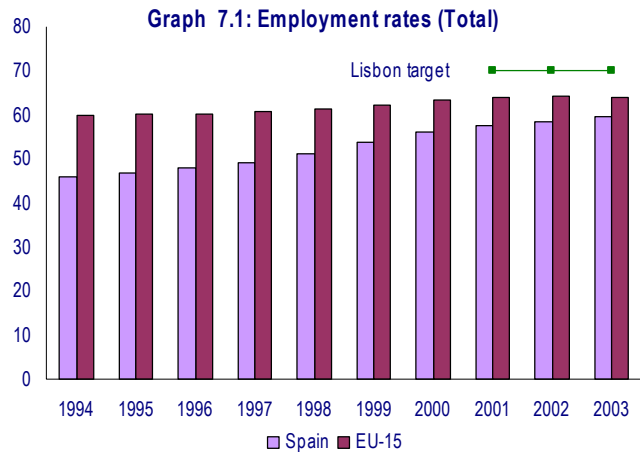
1. Labour market

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

Bearing in mind the three-year period available for implementation, the degree of implementation since 2003 is indicated as: “Complete” for (practically) complete; “In progress” where progress is well advanced; “Limited” where the recommendation is only partially addressed and “Insufficient” where no substantial measures going in the right direction have been taken.

Low employment rates are essentially due to lower female participation

Both the employment rate and labour participation are on an upward trend in Spain, but remain significantly below the EU average and the Lisbon target of 70 per cent. The unemployment rate, although on a downward trend, is, at 10.5 per cent, the highest in the euro area. In order to further promote employment growth, an amendment to the 2005 Draft Budget Law has been introduced, according to which small-sized companies, provided that average staff size increases, will enjoy a tax relief for reinvested capital gains.



Whilst male employment rates are at around the EU average, female employment and participation rates, though rapidly increasing, remain at around 46 per cent, well below the EU average of 53 per cent. In this respect, no significant additional measures to those adopted up to 2003 in this area have been announced by the government appointed in April 2004.

No significant changes in the wage bargaining system

Although no new measures have been adopted so far, the government has announced its intention to strengthen collective bargaining so as to better reflect local labour market conditions as well as specific circumstances at the firm level. Indexation clauses are still in force, although their use is not currently creating significant inflationary distortions. However, in general, backward-looking wage indexation introduces distortions in the functioning of the labour market and contributes to inflation persistence. In this respect, the substitution of indexation by other bargaining mechanisms including a closer link between wage increases and productivity growth would lead to more efficient results. A new agreement for civil servants’ wage increases was reached for 2004. According to it, part of the increase would take place through contributions to pension funds as deferred wages and through non-consolidated one-off wage increases.

Labour market remains heavily segmented

No new measures have been implemented in 2004 as concerns the segmentation of the labour market and the share of fixed-term contracts in total employment remains at around 30 per cent, far above the EU level. Nevertheless, the government appears determined to closely monitor the disproportionate use of fixed-term contracts so as to prevent their use beyond their legal purpose of covering temporary needs of firms. However, the reform of the current employment protection legislation has not been addressed yet.

Geographical mobility and rigidities in the housing market are being addressed

The 2003 reform of the personal income tax introduced a higher tax relief for unemployed workers who accept a job implying change of residence. In addition to fiscal incentives on letting already introduced in 2003, the government allocated in 2004 an additional € 1 billion (0.1 per cent of GDP) to the current 2002-2005 housing plan, aiming at enlarging the renting market and improving housing access for those who has been priced out. As a result, the Plan reform includes measures to foster the development of price-controlled housing, transitory subsidies to low-income tenants and subsidies to landlords who rent their dwellings. Their effect might be, however, rather limited, if no additional measures are adopted. Finally, in order to dampen regional disparities by facilitating geographical mobility, the government interconnected regions' unemployment databases at the National Employment Agency level in 2004.

2. Productivity and business dynamism

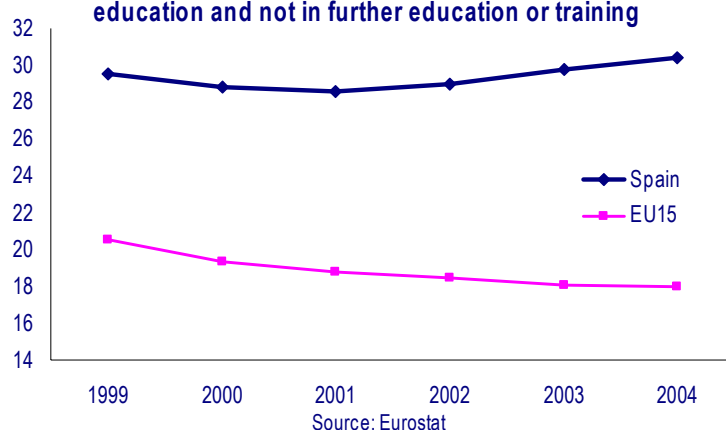
Increase the low level of productivity, including by strengthening the knowledge-based economy in terms of educational attainment and skill levels, investment in IT, R&D and innovation performance	Assessment
Under this challenge, Spain was requested to:	
5. step up efforts to increase skilled human capital, investments in R&D and innovation, and ICT diffusion (GL 13); and	In progress
6. continue to take measures to further enforce effective competition in certain sectors, such as retail distribution (GL 9), pursue ongoing efforts to reduce the administrative burden on business and monitor closely the developments on the electricity market (GL 11).	Limited

Some initiatives have been launched to encourage the transition towards a knowledge-based economy.

The level of educational attainment, as measured by the percentage of the population aged 20 to 24 having completed at least upper secondary education, remains one of the lowest in the EU and the dropout rates from secondary school have not decreased in recent years. In order to improve the situation some measures were taken to develop the *National System of Qualifications and Vocational Training* and

the new government has announced changes to the legislative framework of the education sector. Spain also continues to be one of the worst performers in terms of R&D investment and ICT take ups. The *2004-07 National R&D+I Plan* aims to raise R&D and innovation spending respectively to 1.2 per cent and 2.1 per cent of GDP in 2005. This Plan is currently under revision and, in the meantime, public expenditure in R&D+I will be increased by 25% in the 2005 budget. More R&D tax breaks have been introduced. ICT diffusion is improving,

Graph 7.2: Early school leavers- Percentage of the population aged 18-24 with at most lower secondary education and not in further education or training



albeit from a low level, as measured by the use of computers and internet access by households and businesses and broadband diffusion. Prices for ADSL connections remain high, but the incumbent telecommunications company Telefónica, which is still the dominant firm in the market has doubled the connection speed. The rest of operators have followed suit in order to keep their increasing market share, which coincides with the EU average. The role of the public sector has been pivotal in the transition towards an information society by continuing to promote the use of IT in the public administration. A plan to foster e-government is currently being implemented. In addition the government plans to encourage demand for the newly created services by launching a campaign to raise society's internet awareness as well as a program of digital alphabetisation.

Efforts to increase competition levels have proceeded at a slow pace...

In 2004 efforts were made to achieve the complete transposition of EU competition regulations into Spanish law. In order to increase effective competition the government aims to reinforce the role of the competition authorities and to ensure good coordination with the regional competition authorities that are currently being set up. A white paper on the reform of the Spanish competition framework is currently under preparation. Conditions should be improved for regulators in liberalised network industries to be able to perform their duties in an independent and market oriented fashion. In the retail sector, a draft law was approved establishing the minimum regulatory framework for shops opening hours across all Spanish regions, encouraging higher flexibility and longer opening hours. No progress was achieved this year with respect to the simplification of procedures and liberalisation of restrictions regarding the opening of large stores. This requires negotiations with the regional governments.

...but there is improvement in the environment for business creation.

The opening of more one-stop shops and the extended availability of online facilities have continued to contribute to reducing the time and cost to set up a new business. Changes to the accounting regime for SMEs were adopted in 2004 to simplify compliance with tax and accounting obligations. A new insolvency law was introduced to simplify procedures for winding up companies while adopting a more preventive stance.

The liberalisation process of the electricity sector has moved forward gradually.

Despite full market opening in 2003, the sector is still highly dominated by four vertically integrated firms. The fact that retail tariffs are still fixed while the wholesale market is liberalised hampers the entry of new suppliers. The integration of the Spanish market with neighbouring countries would contribute to increase competition but progress has been limited in upgrading cross border interconnection infrastructures. However, both the creation of the Iberian Integrated Electricity Market (MIBEL) set for the 30th June 2005 and the interconnection target of 10% of domestic demand agreed at the Barcelona Summit of the EU Council are expected to contribute to increase interconnection capacity in the near future. Nonetheless, a significant number of regulatory changes will be needed before the Spanish and the Portuguese market can be truly integrated.

3. Long-term sustainability of public finances

Ensure the long-run sustainability of public finances in the face of population ageing	Assessment
Under this challenge, Spain was requested to:	
7. complement recent initiatives by taking the appropriate steps to implement a major reform of the pension system, so as to strengthen the link between contributions and benefits and control the long-term increases in pension expenditure linked to the foreseen demographic changes (GL 16).	Limited

Progress in ensuring long-term sustainability, but no major measures regarding reforms in the public pension system

In spite of the healthy financial situation of the public pension system in the short run, the sustainability of the Spanish public finances might be threatened in the longer term by the budgetary impact of ageing population. Although the demographic scenario now appears more favourable due to recent net immigration flows, their effect might be only transitory and would only postpone the full budgetary impact. No further steps have been taken to reform the public pension system towards strengthening the relationship between the contributory effort and benefits. However, in the context of the three pronged strategy, a number of measures aiming at enhancing the sustainability of the system should be mentioned. First, the pension reserve fund created in 2000, which received further endowments in the course of 2004 to amount to € 19.3 bn (2.6 per cent of GDP), is planned to reach € 24.7 bn (3.0 per cent of GDP) in 2005. Second, the healthy budgetary position has allowed for a steadily decreasing debt-to-GDP ratio, which is expected to be 47 per cent in 2005. Third, raising participation and employment rates, including through measures in force since 2003 to encourage workers to postpone retirement, would help attenuate the financial impact of ageing. Regarding the second and third pillars, some measures have also been introduced, in particular, the implementation in 2004 of the 2003 agreement to constitute a pension fund by the general government to complement public servants' pensions.

Table 7.1: Economic indicators for Spain

	Spain				EU-25			
	2001	2002	2003	2004	2001	2002	2003	2004
General economic background								
Real GDP growth ¹	2.8	2.2	2.5	2.6	1.8	1.1	1.0	2.5
Inflation ²	2.8	3.6	3.1	3.1	2.5	2.1	1.9	2.2
Labour productivity growth ³	0.3	0.9	0.7	0.6	0.8	0.9	0.9	2.1
Employment growth ¹	2.5	1.7	1.8	1.9	1.0	0.3	0.3	0.4
Nominal wage growth ⁴	3.8	4.3	4.3	3.7	4.0	3.2	3.1	3.0
Current account ⁵	-3.1	-2.7	-3.3	-4.2	:	:	:	:
Unemployment ⁶	10.6	11.3	11.3	11.1	8.5	8.9	9.1	9.1
Public finance								
General government balance ⁵	-0.4	-0.1	0.4	-0.6	-1.2	-2.3	-2.8	-2.8
Primary balance ⁵	2.8	2.7	2.9	1.7	2.4	1.0	0.3	0.2
Cyclically-adjusted balance ⁵	-1.0	-0.5	0.2	-0.7	:	:	:	:
Gross government debt ⁵	57.5	54.4	50.7	48.2	62.1	61.6	63.2	63.5
Employment								
Employment rate ⁷	57.7	58.4	59.7	:	62.8	62.9	63.0	:
Female employment rate ⁸	43.0	44.1	46.0	:	54.3	54.7	55.1	:
Employment rate for older workers ⁹	39.2	39.7	40.8	:	37.4	38.8	40.2	:
Long-term unemployment ¹⁰	3.9	3.9	3.9	:	3.8	3.9	4.0	:
Tax rate on low wage earners ¹¹	33.4	34.0	32.8	:	37.2	37.1	37.4	:
Unemployment trap indicator ¹²	78.8	79.2	78.3	:	78.8	78.5	78.3	:
Product market reforms								
Hourly labour productivity ¹³	83.9	85.3	86.1	:	:	:	:	:
Total trade to GDP ratio ¹⁴	30.8	29.6	28.8	:	30.1	29.2	28.7	:
Internal Market Directives ¹⁵	98.7	98.4	99.1	98.7	:	:	:	96.3
Business investment ¹⁶	22.1	21.7	22.1	:	17.9	17.2	16.8	:
Knowledge-based economy								
Total tertiary graduates ¹⁷	42.1	44.7	:	:	46.8	:	:	:
Spending on human resources ¹⁸	4.4	4.4	:	:	5.1	:	:	:
R&D expenditure ¹⁹	1.0	1.0	1.1	:	1.9	1.9	:	:
Expenditure on IT ²⁰	1.8	1.6	1.6	1.5	3.1	2.9	2.9	2.9

¹ Growth rate in percentage.

² Annual average rate of change in harmonised index of consumer prices in percentage.

³ Growth rate of real GDP per occupied person in percentage.

⁴ Growth rate of compensation per employee.

⁵ As a percentage of GDP.

⁶ Number of unemployed as a percentage of the labour force.

⁷ Employed persons aged 15-64 as a share of the total population of the same age group.

⁸ Employed women aged 15-64 as a share of the total female population of the same age group.

⁹ Employed persons aged 55-64 as a share of the total population of the same age group.

¹⁰ Long-term unemployed (over 12 months) as a percentage of the total active population aged 15-64.

¹¹ Income tax plus employer/employee contributions as a percentage of labour costs of a single earner at 67% of the Average Production Worker-wage, no children.

¹² Effective tax rate on labour income taking into account the combined effect of increased taxes and benefits withdrawal as an individual moves from unemployment back to work earning 67% of the Average Production Worker-wage, measured at the first month of unemployment (after any 'waiting period' if applicable).

¹³ GDP per hour worked in PPS, EU-15=100.

¹⁴ Percentage, average value of imports and exports of goods and services divided by GDP, multiplied by 100. For DE, ES, FR, IT, PL and the UK the value for EU-25 is the total for the large Member States, for all the other states the value for EU-25 is the total for the small Member States.

¹⁵ Percentage implemented in November 2004.

¹⁶ Gross fixed capital formation by the private sector as a percentage of GDP.

¹⁷ Total tertiary graduates (ISCED 5-6) per 1000 of population aged 20-29.

¹⁸ Public expenditure on education as a percentage of GDP.

¹⁹ GERD Gross domestic expenditure on R&D as a percentage of GDP.

²⁰ Expenditure on information technology as a percentage of GDP.

Source: Commission services (incl. Eurostat, structural indicators)

The data for 'general economic background' and 'public finance' are taken from the Commission's Autumn 2004 Economic Forecasts.

8. FRANCE

Introduction

Economic growth was higher in France than in the euro area in 2004. Real GDP growth is expected to have reached 2.4 per cent, as against 2.2 per cent in the euro area. The recovery was driven by the improvement in the global economy and, contrasting with developments in the euro zone, a clear upswing in the domestic components of growth, notably private consumption. In view of the demographic shock that will start affecting the economy by the end of the current decade, the main economic policy challenge faced by France remains the need to foster potential growth through structural reforms both on the labour and the product markets. Another major challenge is ensuring consolidation of government finances in the short run and their sustainability in the longer term. In 2004, some progress was made in bringing the deficit below 3 per cent of GDP: the general government deficit started to decline, to some extent thanks to the unexpectedly strong cyclical upswing and to limits on central government spending. In addition, a comprehensive reform of the health insurance system was introduced. This followed the implementation in 2003 of a major pension reform, which will also have clear positive effects on the labour market in the long run. Limited progress was made in the area of labour and product market reforms in 2004, and more has to be done in order to improve economic performance. On average, hourly productivity is one of the highest amongst EU Member States, but this is partly due to the exclusion from the labour market of the less productive workers and to a particularly low number of hours worked per employee. In the area of product markets, France continues to be among the worst performers in terms of both transposition and implementation of internal market directives and efforts have been slow to increase competition in energy markets. A detailed assessment of recent developments in addressing France's key policy challenges is presented in the following sections.

1. Public finances

Reduce rapidly the general government deficit to below 3 per cent of GDP and keep government finances on a steady consolidation path	Assessment
Under this challenge, France was requested to:	
1. achieve an annual reduction in the cyclically-adjusted deficit of 0.8 per cent of GDP in 2004 and of at least 0.6 per cent of GDP or a larger amount in 2005 so as to ensure that the general government deficit is brought below 3 per cent of GDP in 2005(GL 1);	Limited
2. should the recovery in economic activity be stronger than currently expected, allocate any higher-than-expected revenues to deficit reduction and accelerate the reduction in the cyclically-adjusted deficit through the implementation of additional measures. In addition, any budgetary margin stemming from a slower than planned increase in expenditures should be allocated to deficit reduction; and	Insufficient
3. ensure that the budgetary consolidation continues in the years after 2005, namely through a steady reduction in the cyclically-adjusted budgetary deficit by at least 0.5 percentage points of GDP per year or more if necessary to achieve the medium term position of government finances close to balance or in surplus and bring back the debt ratio to a declining path (GL 1).	Limited
Bearing in mind the three-year period available for implementation, the degree of implementation since 2003 is indicated as: "Complete" for (practically) complete; "In progress" where progress is well advanced; "Limited" where the recommendation is only partially addressed and "Insufficient" where no substantial measures going in the right direction have been taken.	

The reduction of the cyclically-adjusted deficit was lower than expected in 2004

In September 2004, the French government confirmed the deficit target for 2004 contained in the draft Budget for 2004 (3.6 per cent of GDP), despite the clear improvement in macroeconomic conditions that had occurred in the meantime. While State expenditure was kept in line with plans (stabilisation in real terms), health and local expenditures were more dynamic than planned. The lack of improvement in the deficit compared to plans is also due to a number of adverse developments. Notably, the 2003 deficit estimate was revised slightly upward (by 0.1 per cent of GDP), causing a negative base effect and the *Conseil d'Etat* partly cancelled a reform of the unemployment insurance system that had foreseen a substantial tightening of eligibility conditions to benefits (0.1 per cent of GDP). All in all, according to Commission services calculations published in the Autumn 2004 forecast, the improvement of the cyclically-adjusted balance in 2004 did not exceed 0.3 per cent of GDP, as against 0.8 per cent recommended.

Concerning 2005, the draft Budget assumes real GDP growth at 2.5 per cent and foresees a decline in the deficit from 3.6 per cent of GDP in 2004 to 2.9 per cent of GDP in 2005. The Commission services projected, in their Autumn 2004 forecast, the 2005 deficit at 3.0 per cent. The same forecast foresees a decline in the cyclically-adjusted balance by 0.7 percentage point of GDP in 2005. This reflects the effects of expenditure restraint but to a larger extent of one-off revenues amounting to ½ per cent of GDP linked to the transfer of the responsibility to the social security sector for the payment of pensions to electricity and gas companies' employees.

In 2004, higher-than-expected tax revenues did not lead to a lower deficit outcome, neither in actual nor in cyclically-adjusted terms.

The stronger-than-expected economic recovery in 2004, when real GDP growth reached 2.4 per cent instead of 1.7 per cent projected in the 2004 Budget Law, triggered additional revenues of about 0.3 per cent of GDP, concentrated in the State sector. On the contrary, the weakness of payrolls triggered lower-than-expected social contributions of about 0.1 percentage point of GDP. As already mentioned, the additional revenues did not lead to an improvement in the 2004 deficit forecast compared to plans, due to adverse developments in other sub-sectors of general government. Therefore, the improvement in the cyclically-adjusted deficit in 2004 was clearly lower than expected. This is also due to the fact that no additional measures were taken to accelerate the reduction in the cyclically-adjusted balance in 2004 when it became clear that the economic recovery was stronger than expected.

Medium-term projections appear difficult to attain under current policies

The multi-annual budgetary projection accompanying the draft Budget for 2005 assumes real GDP growth at 2.5 per cent per year up to 2008 and projects a decline of the general government deficit by 0.6/0.7 percentage point of GDP per year from 2006 onwards. This is also valid for the year 2006, despite the fact that the implementation of significant tax cuts and the vanishing of the positive impact of the one-off EDF-GDF payment (½ per cent of GDP) will make the deficit reduction more difficult in that year.

Although consistent with a reduction of the cyclically-adjusted deficit by 0.5 percentage point of GDP per year, the projected budgetary effort is not sufficient to bring government finances in a close to balance or surplus situation in nominal terms within the projection period. In 2008, the end-year of the projection period, the general government deficit would still amount to 0.9 per cent of GDP. However in structural terms public finances would approach a close to balance or in surplus position, since the cyclically-adjusted deficit is projected to be reduced to 0.7 percentage point of GDP in 2008. The general government debt ratio would start declining in 2006, but remain above 60 per cent of GDP up to 2008, when it would reach 62 per cent of GDP.

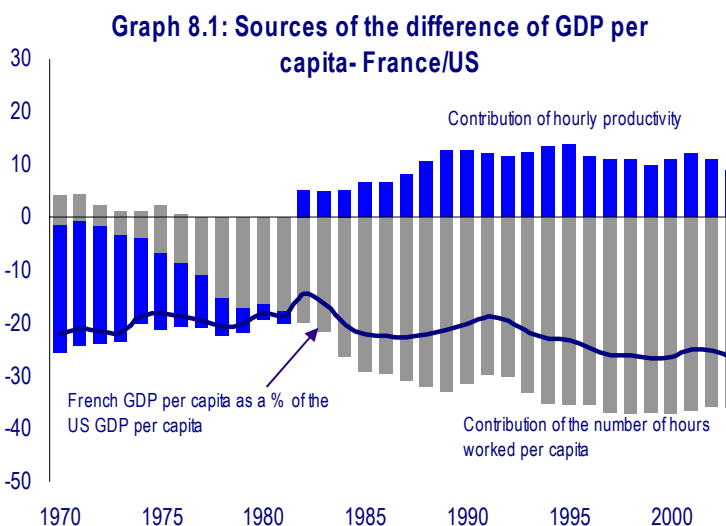
According to the multi-annual projection attached to the Budget, the reduction in the deficit in the years after 2005 would be achieved through ambitious expenditure restraint. General government expenditure is projected to increase by 1.2 per cent per year in real terms, a rate not observed since 1997. Even taking into account the medium-term savings generated by the reform of the health insurance system adopted in 2004, it appears difficult under current policies to keep expenditure in line with these plans, also against the background of the past expenditure slippages compared to multi-annual targets

2. Labour market

Increase labour market participation and reduce structural unemployment	Assessment
Under this challenge, France was requested to:	
4. ensure that the new unemployment insurance system is fully implemented, including appropriate requirements and effective incentives to search a job.	Limited

Labour market performance remains weak, despite recent reforms

France introduced in 2001 a new unemployment insurance scheme. The scheme made it easier for the unemployed to qualify for unemployment benefits and removed the gradual reduction of benefits over time. As a counterpart, sanctions were foreseen in case a jobseeker refuses job proposals with no legitimate reason. In practice, the number of sanctions enforced for insufficient job search has remained very limited. This, combined with the absence of decline of benefits over time, implied that the reform did not have the expected positive impact on job search. In 2003 and in 2004, in reaction to the sharp deterioration of the budgetary situation of the unemployment insurance system, eligibility conditions for unemployment benefits were tightened and their duration was reduced, without however reforming requirements and incentives to search a job. Nevertheless, these changes may have positive effects on job search. Furthermore, the law for social cohesion (LCS), which was adopted by Parliament in Autumn 2004 foresees a reform of public employment services. The ANPE's (*Agence Nationale pour l'Emploi*, the public employment service) monopoly will be abolished and the sanction device will be changed in order to make it easier to implement and therefore improve the incentives to work.



France is one of the industrialised countries with the lowest level of number of hours worked per capita. This reflects both a low employment rate, particularly for young and old workers, and the low number of hours worked per person in employment, especially for full-time workers. As already underlined in the 2004 Implementation Report, important measures have already been taken in order to encourage labour market participation of older workers,

notably in the context of the pension reform of 2003 (introduction of a system reducing the pension amount if the required contribution period is not reached and of a premium system that constitutes a genuine incentive for prolonging the working life beyond the required contribution period). However, recent studies show that incentives to work remain relatively weak for people at and above the legal retirement age, which is at 60 among the lowest in the OECD. Apart from financial incentives, the negative perception by employers and employees of work after 50 or 55 needs to be changed. Concerning other groups, and notably youngsters and people excluded from the labour market, the social cohesion law also foresees a significant increase in subsidised jobs, public employment, and training and apprenticeship. While it may have a positive impact on exclusion in the short run, at a relatively high cost for government finances, the long-term economic effects of the measures proposed in the plan are more uncertain.

Working time has continued to decline over the last decade in France, contrasting with developments elsewhere in the OECD. The ‘Fillon law’ adopted in 2003 introduced more flexibility in the legislation on working time by allowing a larger recourse to overtime hours and reducing their cost. The expected positive impact of this reform on working time is yet to come, mostly because it will take some time for firms to reorganize work and seize the possibilities offered by the law. However, in order to increase the growth potential of the French economy, a further softening of the legislation on working time should be considered. Measures recently announced by the government (increase in the overtime limit, possibility for workers who wish to work longer to do so) are going in the right direction. Another major reform in order to improve labour market performance would be to reduce the stringency of employment protection legislation (EPL). According to several studies, overly tight EPL in France is a major burden on labour demand, and has constituted a barrier for some categories of workers (young and unskilled workers notably) to access the labour market. In this regard, the social cohesion law lacks ambition but goes in the right direction: it loosens the criteria that trigger the complex and long procedure for collective dismissal and it allows social partners to negotiate the schedule of this procedure at the local level.

3. Long-term sustainability of government finances

Ensure the long-term sustainability of public finances in the face of population ageing	Assessment
Under this challenge, France was requested to:	
5. undertake with urgency a comprehensive reform of the pension system (GL 16), with the aim of ensuring its financial sustainability and increasing the effective retirement age, while adapting pension systems to more flexible employment and career patterns as well as to individual needs; and	In progress
6. monitor closely the efficiency of the measures undertaken to curb the dynamics of spending in the health sector so as to reduce it to a sustainable level, and, if necessary, introduce new measures to achieve this objective in the context of the reforms envisaged (GL 14).	In progress

Despite the clear improvement resulting from the implementation of the 2003 pension reform, long-term fiscal trends remain a cause for concern

As reviewed in the 2004 Implementation Report, France implemented a major pension reform in summer 2003. This reform implies notably a gradual increase in the number of contribution years entitling to a full pension over the coming years. A positive aspect of the reform is that it foresees that after 2012 the contribution period should increase proportionally with life expectancy, through a rule meant to keep constant the ratio between

the number of contribution years and the number of pension years. The reform also raises significantly the financial incentives to remain active until and after the legal retirement age, and changes the reference for the indexation of pensions in the public sector from wages to prices. According to the French authorities, this reform will cover around 40 per cent of the financing requirements of the pension system in 2020. Therefore, although the reform undeniably constitutes a large improvement compared with the previous situation, it is not sufficient to neutralise all the medium-term consequences of ageing on the pension system. In addition, the ageing population will continue to impact on the financial situation of the pension system after 2020 and until 2050, a new round of projections is currently being held by the European Commission and by the French Retirement Guidance Council in order to evaluate this impact more precisely. Further reforms will in any case be necessary in the next few decades to ensure the long-term sustainability of the pension system. The 2003 pension reform foresees a discussion on this issue between the government and social partners in 2008.

The reform of the health insurance system is a major step in the right direction

The deficit of the health insurance system has increased rapidly over the last few years to reach 0.8 per cent of GDP in 2004. This reflected mostly the buoyancy of expenditure since 2000 despite several attempts by the government to curb its dynamics. It has led the French authorities to adopt in summer 2004 a major reform of the health system. The aim of the reform is to bring the health insurance system to budgetary balance in 2007, while preserving the quality of the health service. About one third of the effort is planned to be achieved through tax increases representing ¼ per cent of GDP; the remainder through expenditure savings. These savings are supposed to stem notably from (i) the introduction of a charge of one euro payable by patients for every medical consultation starting in January 2005; (ii) measures aimed at tackling fraudulent sick leave and at facilitating the development of generic drugs; and (iii) better control of medical control supposed to stem notably from the introduction of financial incentives for patients to use general practitioners rather than going straight to specialists. Although the reform is likely to trigger substantial savings over time, the precise budgetary impact of some expenditure-saving measures is highly uncertain. Notably, the large savings expected from the medical cost control - representing one-third of the total expected savings - seems at risk, and highly dependent on the behaviour of economic agents involved.

4. Product markets

Ensure effective competition in the network industries and accelerate the adoption of internal market measures, in order to create a level playing field	Assessment
Under this challenge, France was requested to:	
7. pursue efforts to ensure competition in energy markets, namely in gas and electricity	Limited
8. sustain the efforts to reduce and simplify business regulations (GL 11);	In progress
9. raise the transposition rate of internal market directives and bring down the number of infringement proceedings (GL 9).	Limited

Efforts have been made to increase competition in energy markets

As requested by the European Directives on Energy, 70 per cent of the French energy market has been opened up to competition in July 2004. All non household users are now eligible to freely choose their energy supplier. A law, adopted in August 2004, has also transposed the EU recommendations on the rules governing the transport and distribution of energy.

Nevertheless, the incumbents still retain a strong dominant position. For instance, EDF and GDF still respectively have market shares of 78 per cent and 80 per cent of the open market. The conditions imposed on new entrants remain restrictive and the unbundling of distribution activities in both sectors has not yet been fully carried out. In addition, according to the International Energy Agency (2004), the government still has the final authority on tariff-setting. Finally, as requested by the directives, the energy market will only be opened up for all customers in 2007, although other European countries have already made that step.

The reduction and the simplification of business regulation should be pursued

The economic initiative law adopted by the French Parliament in July 2003 sought to increase the birth and survival rates of enterprises and to promote entrepreneurship. It seems that it has started to bear some fruits. After an important increase in the number of firms created in 2003, the results for the first nine months of 2004 show again a strong progression (+16.8 per cent compared to the same period in 2003). However, the number of new enterprises with more than one employee is stable and the survival rate of these newly born firms still has to be assessed. Besides, according to the last global entrepreneurship monitor report, France is still, in terms of level, amongst the countries with the lowest entrepreneurial activity. The complexity of fiscal and social regulations remains a business constraint, particularly for SMEs, which usually do not have a sufficient financial capacity for detailed advice from tax experts. This complexity is one of the factors which explain why, in the last report of the World Bank on the best locations to do business, France does not appear as a top performer.

The transposition rate of internal market directives has slightly increased

Following an initiative from the government to transpose some European laws via an accelerated procedure, the transposition rate of internal market directives has slightly increased at 96.8 per cent in 2004 against 96.5 per cent in 2003. However, this is still well below the EU target for transposition of 98.5 per cent. Regarding infringements, France's performance is still the second worst amongst the old EU Member States, even if the situation in that field has slightly improved recently. Finally, France has still the second highest number of directives overdue for more than 2 years (4 directives not transposed) but this number has been significantly reduced (in 2003 France has 9 directives overdue for more than 2 years).

**Graph 8.2: Number of 2 years overdue directives (2004)
(Lisbon target=no 2 years overdue directives)**

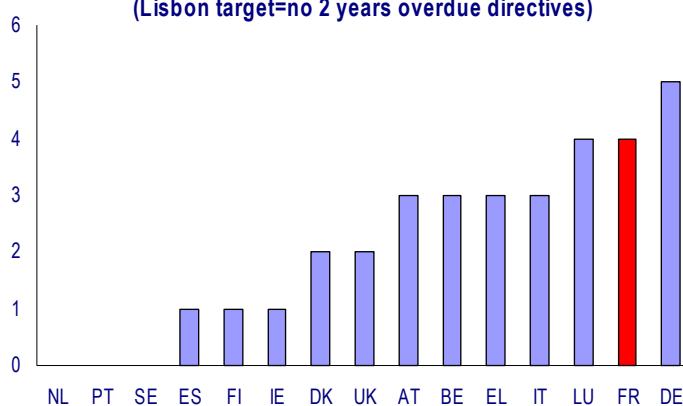


Table 8.1: Economic indicators for France

	France				EU-25			
	2001	2002	2003	2004	2001	2002	2003	2004
General economic background								
Real GDP growth ¹	2.1	1.2	0.5	2.4	1.8	1.1	1.0	2.5
Inflation ²	1.8	1.9	2.2	2.3	2.5	2.1	1.9	2.2
Labour productivity growth ³	0.2	0.2	0.4	2.7	0.8	0.9	0.9	2.1
Employment growth ¹	1.9	0.9	0.1	-0.3	1.0	0.3	0.3	0.4
Nominal wage growth ⁴	2.7	2.4	2.3	3.3	4.0	3.2	3.1	3.0
Current account ⁵	1.5	1.5	0.4	-0.2	:	:	:	:
Unemployment ⁶	8.4	8.9	9.4	9.6	8.5	8.9	9.1	9.1
Public finance								
General government balance ⁵	-1.5	-3.2	-4.1	-3.7	-1.2	-2.3	-2.8	-2.8
Primary balance ⁵	1.6	-0.2	-1.2	-0.7	2.4	1.0	0.3	0.2
Cyclically-adjusted balance ⁵	-2.3	-3.6	-3.8	-3.5	:	:	:	:
Gross government debt ⁵	56.5	58.8	63.7	64.9	62.1	61.6	63.2	63.5
Employment								
Employment rate ⁷	62.8	63	63.2	:	62.8	62.9	63.0	:
Female employment rate ⁸	56	56.7	57.2	:	54.3	54.7	55.1	:
Employment rate for older workers ⁹	31.9	34.7	36.8	:	37.4	38.8	40.2	:
Long-term unemployment ¹⁰	3	3	3.5	:	3.8	3.9	4.0	:
Tax rate on low wage earners ¹¹	38.4	37.6	37.7	:	37.2	37.1	37.4	:
Unemployment trap indicator ¹²	86.6	84	82.6	:	78.8	78.5	78.3	:
Product market reforms								
Hourly labour productivity ¹³	120.6	120.0	122.5	:	:	:	:	:
Total trade to GDP ratio ¹⁴	27.5	26.5	25.7	:	30.1	29.2	28.7	:
Internal Market Directives ¹⁵	97.0	96.2	96.5	96.8	:	:	:	96.3
Business investment ¹⁶	17.0	16.3	15.9	:	17.9	17.2	16.8	:
Knowledge-based economy								
Total tertiary graduates ¹⁷	67.9	:	:	:	46.8	:	:	:
Spending on human resources ¹⁸	5.8	5.8	:	:	5.1	:	:	:
R&D expenditure ¹⁹	2.2	2.3	2.2	:	1.9	1.9	:	:
Expenditure on IT ²⁰	3.5	3.3	3.1	3.1	3.1	2.9	2.9	2.9

¹ Growth rate in percentage.

² Annual average rate of change in harmonised index of consumer prices in percentage.

³ Growth rate of real GDP per occupied person in percentage.

⁴ Growth rate of compensation per employee.

⁵ As a percentage of GDP.

⁶ Number of unemployed as a percentage of the labour force.

⁷ Employed persons aged 15-64 as a share of the total population of the same age group.

⁸ Employed women aged 15-64 as a share of the total female population of the same age group.

⁹ Employed persons aged 55-64 as a share of the total population of the same age group.

¹⁰ Long-term unemployed (over 12 months) as a percentage of the total active population aged 15-64.

¹¹ Income tax plus employer/employee contributions as a percentage of labour costs of a single earner at 67% of the Average Production Worker-wage, no children.

¹² Effective tax rate on labour income taking into account the combined effect of increased taxes and benefits withdrawal as an individual moves from unemployment back to work earning 67% of the Average Production Worker-wage, measured at the first month of unemployment (after any 'waiting period' if applicable).

¹³ GDP per hour worked in PPS, EU-15=100.

¹⁴ Percentage, average value of imports and exports of goods and services divided by GDP, multiplied by 100. For DE, ES, FR, IT, PL and the UK the value for EU-25 is the total for the large Member States, for all the other states the value for EU-25 is the total for the small Member States.

¹⁵ Percentage implemented in November 2004.

¹⁶ Gross fixed capital formation by the private sector as a percentage of GDP.

¹⁷ Total tertiary graduates (ISCED 5-6) per 1000 of population aged 20-29.

¹⁸ Public expenditure on education as a percentage of GDP.

¹⁹ GERD Gross domestic expenditure on R&D as a percentage of GDP.

²⁰ Expenditure on information technology as a percentage of GDP.

Source: Commission services (incl. Eurostat, structural indicators)

The data for 'general economic background' and 'public finance' are taken from the Commission's Autumn 2004 Economic Forecasts.

9. IRELAND

Introduction

The Irish economy is undergoing a significant adjustment to a pace of sustainable growth in the medium term of around 5 per cent. While still impressive, the extraordinary growth performance of the second half of the 1990s, then mainly due to a high inflow of foreign direct investment and sizeable pool of available labour, is unlikely to be repeated. The economy's ability to sustain relatively high growth rates and a low unemployment rate in recent years constitutes evidence of its inherent flexibility. In 2004, Ireland's economic policy agenda built on both extending previous and introducing additional measures to promote stable macroeconomic conditions, strengthening the supply-side and increasing the degree of competition. Concerns about the level and quality of public services and infrastructure have led to the government stepping up its efforts to secure value for money. As regards wage costs and competitiveness, some further easing of pressures can be expected over the medium term: fairly moderate pay provisions were agreed in summer 2004 for the second half-period of the 2003-2005 national agreement "Sustaining Progress". All in all, although some of the structural bottlenecks inherited from the high-growth period of the 1990s remain, measures undertaken in 2004 should facilitate a successful gradual transition towards a pace of sustainable growth. A detailed assessment of recent developments in addressing Ireland's key policy challenges is presented in the following sections.

1. Macroeconomic conditions and supply-side measures

Achieve a smooth transition from double-digit economic growth in the late 1990s to lower, sustainable growth in the years ahead by ensuring stable macroeconomic conditions and by strengthening the supply-side of the economy	Assessment
Under this challenge, Ireland was requested to:	
1. enhance the efficiency of public expenditure and improve revenue and expenditure planning in a stability-oriented medium-term framework building on the range of measures recently introduced to improve the planning, management and control of expenditure (GL 14);	In progress
2. encourage the social partners to adhere to a prudent and flexible wage norm to allow for adaptation to productivity and skill differentials and at the same time safeguard competitiveness (GL 3 and 5);	In progress
3. prioritise the roll-out of the infrastructural elements of the National Development Plan, while preserving budgetary stability, and pursue policy measures to raise the level of R&D (GL 13); and	In progress
4. increase competition in the network industries and in certain sectors of the economy, such as retail distribution (including the liquor trade), insurance and the professions (GL 9).	Limited
Bearing in mind the three-year period available for implementation, the degree of implementation since 2003 is indicated as: "Complete" for (practically) complete; "In progress" where progress is well advanced; "Limited" where the recommendation is only partially addressed and "Insufficient" where no substantial measures going in the right direction have been taken.	

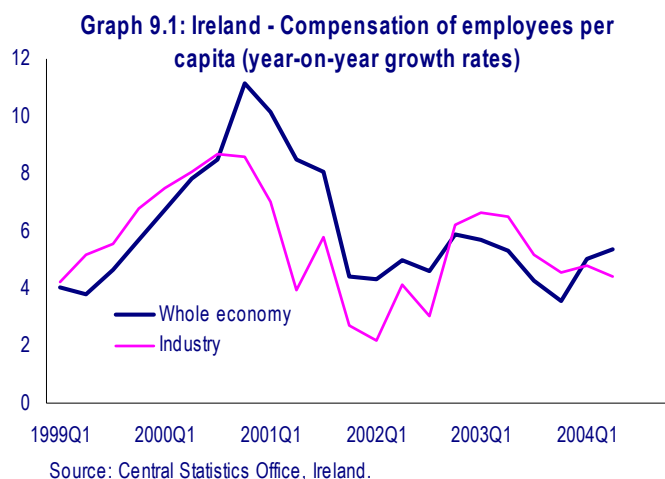
Further measures to strengthen the budgetary framework are taken

As noted in the 2004 Implementation Report, deviations from revenue targets in recent years have led to tax forecasting procedures remaining under official review. A new provisional methodology for forecasting corporation tax revenues in the period 2004 to 2006 was introduced in the 2004 Budget. Developmental work is ongoing in the Department of Finance and the Revenue Commissioners in examining the possibilities for refining the methodologies for forecasting tax revenues received under the major tax heads. As regards the management of expenditure, discretionary spending has been maintained closer to plans in recent years. From the 2004 budget, the medium-term framework has been strengthened by extending the system of rolling multi-annual (five-year) spending envelopes from public transport to all areas of capital spending. In addition, a limited carryover under the capital envelopes was made possible from one year to the next. These measures should encourage efficiency and increase the transparency of expenditure policy (see also below).

Given constraints on the revenue side, including the wish to maintain a relatively low tax burden, the government has taken a number of initiatives to improve efficiency and control of expenditures, especially in high-priority areas such as health and infrastructure. As outlined in the 2004 Implementation Report, the government's health reform programme (announced in June 2003) will take several years to complete. Detailed planning on the health reform programme progressed during 2004 and further legislation is due in 2005. The Health Service Executive, a key new structure to manage services on a national basis, has replaced the regional health board structure as from 1 January 2005.

Wage agreement should tend to protect competitiveness

In recent years, higher inflation than in Ireland's main trading partners coupled with the strength of the euro have been at the centre of increasing competitiveness concerns. However, wage growth eased markedly since end-2002, illustrating Ireland's capacity to respond flexibly to changing circumstances. More recently, the annual growth in compensation has stabilised at around 5 per cent, with the latest data showing a gradual decline in the industry sector. Overall, Irish economic conditions remain strong, with low unemployment, healthy employment growth and resilient exports.



In the medium term, wage moderation in the private sector should be fostered by the relatively moderate provisions of the new 18-month pay deal from June 2004 in the framework of the national agreement Sustaining Progress. The pay deal provides for a slightly higher wage increase of low-paid workers. In the public service, Sustaining Progress provides, in addition to regular pay rises, for the gradual implementation by mid-2005 of an average 8.9 per cent rise under "benchmarking", a process to align pay scales more closely with those for comparable jobs in the private sector. In line with the government's commitment to secure value for money, payment of three-quarters of the awarded increase and the general round increases under Sustaining Progress is conditional on verifiable progress in public sector modernisation and flexibility and the maintenance of industrial peace. In the course of 2004, the performance verification groups put in place in 2003 agreed the payment of the benchmarking and general round increases in 2004.

Measures to improve capital spending and to increase R&D have been implemented

The record growth rates of the 1990s have led to congestion and other infrastructure constraints in some areas, which the government has been trying to address primarily through the National Development Plan 2000- 2006 (NDP). The government has sustained efforts to increase investment in infrastructure. In October 2003, an independent mid-term review of the National Development Plan, which was commissioned by the government and the European Commission, reported that progress has been made in investing in infrastructure such as roads, public transport and social housing. As outlined in the 2004 Implementation Report, the review also made several recommendations including the desirability of multi-annual budgeting, further strengthening value for money and timeliness of physical delivery (which, in some cases, has been behind schedule). In the budget for 2005, the capital envelopes contained a commitment to maintain public investment over the period 2005-2009 at close to 4% of GDP, well above the EU average for 2004 of around 2½%. On management and cost control, the government has continued to encourage 'public-private partnerships'. Work is also continuing on changes in the areas of public sector construction contracts by transferring appropriate risks to contractors, in order to improve cost control of projects and facilitate budget planning in the years ahead. In 2004, a number of NDP projects were completed, in some cases ahead of schedule. For example, there were reported completions of broadband projects and road by-passes but an example of where physical delivery has been behind schedule is with the Dublin Light Rail System (LUAS), where there have been serious problems with delays and costs. Other developments in 2004 include the publication of 5bn euro investment programme for 2004-2006 in new water and sewerage infrastructure.

The government has stated its commitment to pursuing the objective of increasing investment in R&D and innovation. Under the NDP, euro 2.5bn was allocated to research, technological development and innovation across a range of sectors. Part of this funding has been directed towards major research centres. The 2004 budget included an incentive measure to increase private sector participation in R&D projects by the introduction of a 20 per cent tax credit for incremental R&D expenditure. Latest data show that measures taken in this field have helped to increase the level of R&D expenditure in Ireland, although it remains below the EU average.

Limited progress in increasing competition.

Further measures have been taken to continue liberalising network industries. In 2004, postal services, electricity and gas were further liberalised to comply with European Directives. In postal services outbound cross border mail services are now fully open to competition. In February 2004, market opening of the electricity sector increased from 40 per cent to 56 per cent by volume. All large customers and many SMEs are now eligible to source from licensed suppliers other than the state-owned Electricity Supply Board. For gas networks, an order came into effect in July 2004 which makes all non-household customers eligible to source from independent suppliers.

However, there has been little progress in addressing competition issues in other sectors of the economy in 2004. The government is currently considering legislative proposals to remove a limited number of restrictions on the location and number of pharmacies. Following recommendations made in 2003 by the commission on liquor licensing the government is expected shortly to publish a comprehensive scheme of a bill to liberalise licensing. The government also recently established a review group to examine the auctioneering and estate agency professions, which is expected to report in early 2005. Finally, no new measures have been taken to address the competition problems in the insurance sector.

Table 9.1: Economic indicators for Ireland

	Ireland				EU-25			
	2001	2002	2003	2004	2001	2002	2003	2004
General economic background								
Real GDP growth ¹	6.0	6.1	3.7	5.2	1.8	1.1	1.0	2.5
Inflation ²	4.0	4.7	4.0	2.3	2.5	2.1	1.9	2.2
Labour productivity growth ³	2.9	4.3	1.6	2.7	0.8	0.9	0.9	2.1
Employment growth ¹	3.0	1.8	2.0	2.4	1.0	0.3	0.3	0.4
Nominal wage growth ⁴	7.7	5.0	4.7	5.4	4.0	3.2	3.1	3.0
Current account ⁵	-0.7	-1.3	-1.4	-1.6	:	:	:	:
Unemployment ⁶	3.9	4.3	4.6	4.4	8.5	8.9	9.1	9.1
Public finance								
General government balance ⁵	0.9	-0.2	0.1	-0.2	-1.2	-2.3	-2.8	-2.8
Primary balance ⁵	2.4	1.1	1.4	1.2	2.4	1.0	0.3	0.2
Cyclically-adjusted balance ⁵	-0.3	-1.3	0.1	0.1	:	:	:	:
Gross government debt ⁵	35.9	32.7	32.1	30.7	62.1	61.6	63.2	63.5
Employment								
Employment rate ⁷	65.8	65.6	65.4	:	62.8	62.9	63.0	:
Female employment rate ⁸	55	55.6	55.8	:	54.3	54.7	55.1	:
Employment rate for older workers ⁹	46.5	47.1	49	:	37.4	38.8	40.2	:
Long-term unemployment ¹⁰	1.2	1.3	1.5	:	3.8	3.9	4.0	:
Tax rate on low wage earners ¹¹	17.3	16.7	16.7	:	37.2	37.1	37.4	:
Unemployment trap indicator ¹²	72.6	73.4	73.3	:	78.8	78.5	78.3	:
Product market reforms								
Hourly labour productivity ¹³	108.7	116.3	113.2	:	:	:	:	:
Total trade to GDP ratio ¹⁴	91.0	84.4	76.0	:	:	58.8	57.2	:
Internal Market Directives ¹⁵	97.2	98.6	98.6	97.5	:	:	:	96.3
Business investment ¹⁶	19.3	18.2	19.7	:	17.9	17.2	16.8	:
Knowledge-based economy								
Total tertiary graduates ¹⁷	70.9	70.9	:	:	46.8	:	:	:
Spending on human resources ¹⁸	4.4	:	:	:	5.1	:	:	:
R&D expenditure ¹⁹	1.2	1.1	1.1	:	1.9	1.9	:	:
Expenditure on IT ²⁰	2.1	1.8	1.7	1.6	3.1	2.9	2.9	2.9

¹ Growth rate in percentage.

² Annual average rate of change in harmonised index of consumer prices in percentage.

³ Growth rate of real GDP per occupied person in percentage.

⁴ Growth rate of compensation per employee.

⁵ As a percentage of GDP.

⁶ Number of unemployed as a percentage of the labour force.

⁷ Employed persons aged 15-64 as a share of the total population of the same age group.

⁸ Employed women aged 15-64 as a share of the total female population of the same age group.

⁹ Employed persons aged 55-64 as a share of the total population of the same age group.

¹⁰ Long-term unemployed (over 12 months) as a percentage of the total active population aged 15-64.

¹¹ Income tax plus employer/employee contributions as a percentage of labour costs of a single earner at 67% of the Average Production Worker-wage, no children.

¹² Effective tax rate on labour income taking into account the combined effect of increased taxes and benefits withdrawal as an individual moves from unemployment back to work earning 67% of the Average Production Worker-wage, measured at the first month of unemployment (after any 'waiting period' if applicable).

¹³ GDP per hour worked in PPS, EU-15=100.

¹⁴ Percentage, average value of imports and exports of goods and services divided by GDP, multiplied by 100. For DE, ES, FR, IT, PL and the UK the value for EU-25 is the total for the large Member States, for all the other states the value for EU-25 is the total for the small Member States.

¹⁵ Percentage implemented in November 2004.

¹⁶ Gross fixed capital formation by the private sector as a percentage of GDP.

¹⁷ Total tertiary graduates (ISCED 5-6) per 1000 of population aged 20-29.

¹⁸ Public expenditure on education as a percentage of GDP.

¹⁹ GERD Gross domestic expenditure on R&D as a percentage of GDP.

²⁰ Expenditure on information technology as a percentage of GDP.

Source: Commission services (incl. Eurostat, structural indicators)

The data for 'general economic background' and 'public finance' are taken from the Commission's Autumn 2004 Economic Forecasts.

10. ITALY

When compared with the euro area average the slow response of the Italian economy to the strong expansion of the global economy in 2004 bore witness to the structural challenges of the country's economic system. Highlighting the unresolved issue of competitiveness, the impact of reviving domestic demand on growth was dampened by a comparatively strong leakage to foreign markets which in turn was only partially offset by foreign sales. The loss of market shares continued. In terms of supply side factors, the ongoing resilience of employment in the face of measured real GDP growth further underscored the issue of low productivity, which has affected Italy's growth potential in the recent past. Against this background the economic reform effort proceeded at a variable pace. Following the pattern observed since 2001, fiscal policy largely relied on one-off measures adjourning a lasting consolidation of public finances warranted by the high debt to GDP ratio. The first part of the labour market reform aimed at reducing frictions and further increasing flexibility is being successively implemented, but little to no attention was focused on the revision of employment protection legislation and unemployment benefits. The pension reform was eventually adopted in 2004 yet will produce significant budgetary savings after 2008. The low level of investment in ICT and the low innovation capacity continue to be a drag on the productivity level and growth. In products and services markets, specific achievements were mitigated by the still high degree of regulation and a lack of competition, especially in the professional services sector. Overall, in 2004 the government's strategy was chiefly tilted towards securing recent reform steps while prioritizing the reduction of taxes on the outstanding reform agenda. A detailed assessment of recent developments in addressing Italy's key policy challenges is presented in the following sections.

1. Public finances

Rapidly consolidate public finances	Assessment
Under this challenge, Italy was requested to:	
1. take appropriate measures to avoid the occurrence of an excessive deficit; move towards achieving 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 per cent of GDP per year, replacing one-off measures by measures of a more permanent character;	Limited
2. strengthen policy co-ordination between all levels of government, by ensuring adequate and transparent enforcement mechanisms for fiscal discipline, while providing for clear sources of financing regional spending; and	Limited
3. finance further reductions in the tax burden through structural cuts in current primary expenditure within a comprehensive reform plan on both the expenditure and the revenue side.	Limited
Bearing in mind the three-year period available for implementation, the degree of implementation since 2003 is indicated as: "Complete" for (practically) complete; "In progress" where progress is well advanced; "Limited" where the recommendation is only partially addressed and "Insufficient" where no substantial measures going in the right direction have been taken.	

Fiscal consolidation further postponed

Against the background of a mild economic recovery the deficit-to-GDP ratio increased to 3.0 per cent in 2004, according to the Commission's Autumn 2004 Economic Forecasts, up from 2.4 per cent in the year before. The worsening of the fiscal position essentially resulted from a gradual reduction of one-off measures coupled with a limited adjustment of the primary expenditure-to-GDP. In cyclically-adjusted terms the primary surplus declined by

0.8 percentage point of GDP, more than the cyclically-adjusted budget balance as a whole, which worsened by 0.5 percentage point of GDP, due to a lower interest expenditure. These figures contrast with the recommendation to ensure a reduction in the cyclically-adjusted deficit of at least 0.5 percentage points of GDP per year until a medium-term budgetary position close to balance or in surplus is achieved. According to the Commission's Autumn 2004 Economic Forecasts, the situation is not expected to improve in the short term, as the cyclically-adjusted budget balance is projected to further worsen in 2005 and the deficit to stay at 3 per cent of GDP even in case the planned budgetary correction is fully implemented. The deterioration of the cyclically-adjusted balance also reflects the decrease in temporary measures, not yet compensated by permanent ones. One-offs declined from over 2 per cent of GDP in 2003 to around 1½ of GDP in 2004 and are planned to amount to ½ of GDP in 2005.

The prospect of increased autonomy competes with efforts to curb regional spending

The domestic stability pact proved effective in enforcing fiscal discipline on local governments in the recent years. Moreover, concerning 2005, the budget includes a provision aimed at further improving the monitoring of the local government accounts, both in accrual and in cash terms. Conversely, attempts to control health care expenditure, which is under the authority of regional governments, have been decisively less successful. The draft 2005 budget fixed an ambitious target for health care expenditure, entailing a cut in nominal terms compared to 2004. Taking also into account the freeze of local and regional taxation until 2006, the achievement of the expected savings will crucially depend on an improvement in the monitoring and enforcement mechanisms. The Parliament is currently working on a major constitutional reform which will devolve a broad range of responsibilities to the regions which are currently exercised by the central government. However, no final agreement has been reached so far on how to endow the regions with the resources needed to exercise the new powers.

Net of one-offs, revenues fall short of primary current expenditure

The declining reliance on temporary measures from over 2 per cent of GDP in 2003 to 1½ per cent of GDP in 2004 disclosed a gap between revenue and expenditure trends, which needs to be closed with structural measures in order to achieve fiscal adjustment. The draft 2005 budget introduced a new expenditure target for the 2005-2007 period consisting of a 2 per cent ceiling on the annual nominal increase of primary expenditure, excluding pensions, with respect to the previous year. However, the new target was not accompanied by legislation defining its practical implementation, in particular for expenditure of regions. It relies on a strong political commitment and envisages a marked change in the behaviour of all levels of government. Any departure from the ambitious budgetary plan for 2005, involving a fiscal correction of 1.7 per cent of GDP, could lead to a deficit above the 3 per cent of GDP reference value. The tax cuts announced by the government for 2005 and beyond are not fully financed by structural measures on current expenditure.

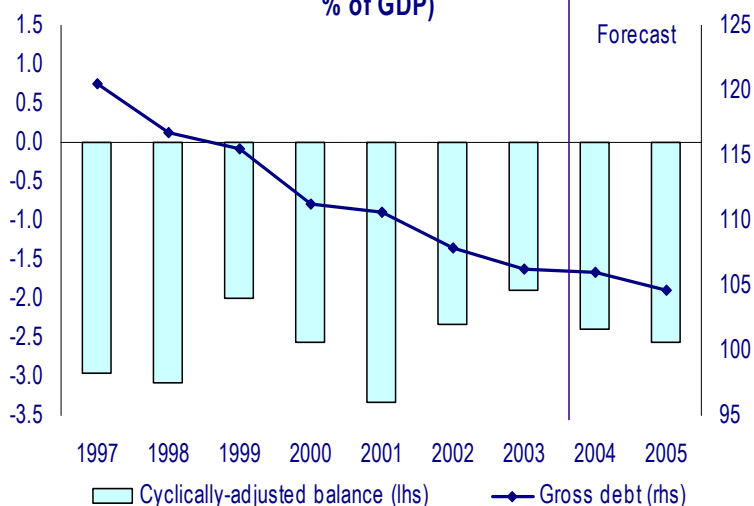
2. Long-term sustainability of public finances

Ensure the long term sustainability of public finances in the face of population aging	Assessment
Under this challenge, Italy was requested to:	
4. ensure that the debt ratio is diminishing at a satisfactory pace towards the 60 per cent of GDP threshold; and	Insufficient
5. adopt further measures to address the critical issue in the public pension system, in particular the long transition period to the new contributions-based system. The new system has been designed just to deal with adverse demographic shocks and promote supplementary privately funded pension schemes.	Limited

The pace of debt reduction remains slow

The assessment of public debt is essentially unaltered compared with the 2003 implementation report. The still very high debt to GDP ratio continues to decline at a very slow pace. In 2004 it was at 106.0 per cent of GDP, only two decimal points lower than the year before in spite of significant privatisation proceeds totalling 0.7 per cent of GDP. Nominal GDP growth was essentially in line with official projections. Apart from the slippage in the primary surplus, the inertia of the debt is largely explained by the high levels of the cash borrowing requirement, which since 1999 has consistently exceeded the Maastricht definition of general government deficit. This difference has weighed over 9.5 percentage points of GDP on the reduction of the debt. Moreover, the divergence between the cash borrowing requirement and the Maastricht deficit would seem to persist in future years according to the government's own medium-term projections presented in the 2004 update of the stability programme. As a consequence, the officially targeted decline in the debt to GDP ratio of around 2 percentage points on average per year in the 2005-2008 period presumes significant fiscal corrections and large proceeds from disposals of financial assets. The primary surplus is planned to increase from 2½ of GDP in 2004 to close to 5 per cent in 2008 and disposals of financial assets are expected to yield on average over 1.5 per cent of GDP year. Nevertheless, the privatisation plan appears particularly challenging by historical standards. Stepping up the reduction of the debt ratio with respect to both the past and plans remains one of the key challenges for Italy.

Graph 10.1: ITALY: Debt and CAB developments (in % of GDP)



The pension reform sets stricter requirements for early retirement from 2008

In 2004 the Parliament approved the pension reform originally presented by the government three years earlier. The tightening of the eligibility criteria to qualify for a seniority pension constitutes a positive step towards a shortening of the transition period to the new demographic shocks. However, the stricter provisions will apply only from 2008 onwards, when the reform foresees a sharp tightening of eligibility criteria, exacerbating the systems discontinuities. In addition, uncertainty characterises the ability of the adopted reform to promote the privately-funded pension pillar. The new legislation also aims to kick-start privately-funded schemes by diverting the annual flow of funds currently accounted by employers as *trattamento di fine rapporto* (a kind of severance payment that employers are obliged to accumulate each year and that is returned to workers at the end of the work relationship). As workers have the possibility to keep the money with the firm instead of transferring it to private pension funds, the development of the latter will also depend on the individual choices made.

3. Labour market and regional development

Raise the low employment rate, especially among women and older workers, and reduce the wide North-South economic disparities	Assessment
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Under this challenge, Italy was requested to:

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

Implementation of first part of labour market reform advances...

In 2004 the government proceeded with the implementation of the first part of the government's labour market reform plan - the so called 'Biagi' law - which had formally entered into force in October 2003. A series of ministerial decrees were adopted to make the reform law operational. In particular, the government successfully activated a number of new, more flexible labour contracts and effectively opened and liberalised the employment service sector to private firms. Both strands have the potential to increase labour force participation. The national on-line information and matching system (*borsa continua nazionale del lavoro*), which is also part of the 'Biagi' law, is still under construction. Based on legislation adopted in 2002 the Minister of labour and social policies in 2004 started selecting projects for child-care facilities at the firm level eligible for financial support. However, the initiative was blocked by the Constitutional court as it falls into the remit of the regions. Because of its recent implementation there are no clear cut indications about the likely effects of the 'Biagi law'. Employment growth slowed only slightly in 2004 exhibiting the traditional lag compared to economic activity. The rate of unemployment continued to follow the downward path of the past several years. Concerning labour market data it needs to be stressed that in 2004 the national statistical office carried out a major revision of the labour force survey in 2004 with a view to harmonising national statistics with EU legislation. The major implication of the revision is an upward shift in employment and a downward shift in the number of unemployed people. In 2003, the latest year for which 'new' and 'old' figures are available, the revision of the labour force survey led to an increase in the rate of employment from 56.0 per cent to 57.5 per cent. Despite the improvements observed over the recent past, the distance to the EU average of more than 64 per cent remains significant.

...heightening the need for further steps

While satisfying the need for more flexibility, there is the preoccupation that the increased variety of labour contracts may further heighten the already visible segmentation of the Italian labour market. Employees in large manufacturing firms with a standard contract generally have a better job protection and enjoy more generous benefits in case of unemployment than workers with new non-standard contracts. The second and actually integral part of the reform plan, which was supposed to address the issue of segmentation, has made no progress. In particular, the draft law proposing a marginal loosening of the employment protection legislation (EPL) as well as the revision and broadening of the too segmented unemployment benefit system is not making progress in Parliament. It has been put aside as priority was given to the reform of the pension system. The latter also includes a fiscal incentive for employees aimed at postponing their retirement decision which became

effective in 2004. As the incentive became operational only in October no definitive assessment can be made. From an economic point of view the incentive would seem to merely change the distribution of income over time without increasing permanent income. However, preliminary indications on the number of applications point to a positive reception by potential beneficiaries.

Talks about a revision of the wage setting mechanism eventually started

In clear contrast to past years, when trade unions had firmly refused to discuss a revision of the centralised wage setting mechanism, social partners started talks in 2004 with a view to exploring possible changes. Two of the three leading trade unions explicitly signalled their willingness to discuss the option of regional negotiations and more generally to allow wages to better reflect different productivity conditions. However, the idea of regional wage agreements is strongly opposed by the largest trade union which has officially abandoned the talks. Progress in the field of wage differentiation would be instrumental for narrowing the large employment and ultimately the income gap between the North and the South of the country. This is recognised by the government, which encourages social partners to continue their talks without interfering. The strong divergence of views across trade unions is likely to preclude a quick agreement on the issue.

4. Knowledge-based economy

Strengthen the knowledge-based economy in terms of educational attainment and skill levels, investment in IT, R&D and innovation performance	Assessment
Under this challenge, Italy was requested to:	
9. pursue efforts undertaken to raise the overall education and skill base of the population, to further increase investment in R&D and innovation and to promote higher ICT take up, in particular through measures targeted at small and medium enterprises (GL 13).	Limited

A still weak innovation capacity ...

Despite some progress, the level of educational attainments, the skill levels and the number of researchers remain far below the EU average, which limits the availability of skilled human resources, reduces the capacity of absorption of new technologies and impinges on the overall innovative capacity. In 2003, steps were taken to implement a comprehensive reform of the school system. The past reforms of the universities have also started showing results (increase in number of university graduates, international mobility of the students). The Italian Institute of Technology has been created with the mandate to stimulate research and scientific competition. Nevertheless R&D expenditure, public sector and private sector expenditures remain among the lowest in the EU and demonstrate a relatively low average annual growth rate. Moreover, although increasing, the share of state aids redirected to the horizontal objective of steering investment towards R&D remains low. In this respect, the tax cut for firms hiring researchers is welcome. Little progress has been made regarding IT use and diffusion: IT expenditures have decreased as a percentage of GDP and internet and broadband access, while increasing, remain also below the EU-15 average.

5. Business environment

Continue to improve the business environment and to enhance competition in the energy and service sectors	Assessment
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Under this challenge, Italy was requested to:	
10. improve the business environment by reducing the administrative burden on businesses (GL11); and	In progress
11. increase effective competition in the service sector, widen the opening of energy markets, and improve the implementation of internal market directives (GL 9).	Limited

High propensity towards entrepreneurship

Following the Simplification law voted in 2003, efforts have continued to simplify the regulatory framework, in particular through the automatic cancellation from the register of firms that are no longer active. The cost, the number of procedures, and time required for business start-up have decreased considerably. Relative progress was made in e-government as measured by the number of services available online. A new corporate income tax system (IRES) became effective in January 2004 lowering the tax rate by 1 percentage point to 33 per cent and foreseeing some temporary tax deductions for investment in intangible assets (including items generally classified as R&D expenditure). The new Corporate Law also improves access to finance for businesses (private equity and venture capital).

The liberalisation of the energy sector proceeds but the competition is not effective yet ...

In the natural gas industry, the incumbent maintains a dominant position in the supply of both imported and domestically produced gas. As requested by the EU directives some measures have been taken to address the competitiveness problems of the electricity sector. The creation of the Electricity Power exchange in April 2004 introduced a market-oriented price mechanism. In spite of ongoing reforms (for example the Marzano Law and a change in the management of the transmission grid), the still imperfect competition in the energy sector contributes to high prices (especially for the larger users). The same conclusion holds for the prices of some telecommunication services, particularly for national calls.

... and limited progress has been made to increase competition in services and to improve the implementation of Internal Market directives.

Italy was well below target in terms of transposition of Internal Market directives and recorded a very high number of infringement cases (95.3 per cent and 149 respectively as of November 2004). A number of proposals to increase competition in the professional services sector have been discussed and examined by the Parliament. Nevertheless, Italy remains the most regulated EU country for professional services (COM2004 (83)).

Table 10.1: Economic indicators for Italy

	Italy				EU-25			
	2001	2002	2003	2004	2001	2002	2003	2004
General economic background								
Real GDP growth ¹	1.8	0.4	0.3	1.3	1.8	1.1	1.0	2.5
Inflation ²	2.3	2.6	2.8	2.3	2.5	2.1	1.9	2.2
Labour productivity growth ³	0.1	-0.9	-0.2	0.5	0.8	0.9	0.9	2.1
Employment growth ¹	1.6	1.3	0.4	0.8	1.0	0.3	0.3	0.4
Nominal wage growth ⁴	3.2	2.5	3.8	3.4	4.0	3.2	3.1	3.0
Current account ⁵	0.3	-0.3	-1.2	-1.0	:	:	:	:
Unemployment ⁶	9.4	9.0	8.6	8.3	8.5	8.9	9.1	9.1
Public finance								
General government balance ⁵	-2.6	-2.3	-2.4	-3.0	-1.2	-2.3	-2.8	-2.8
Primary balance ⁵	3.9	3.5	2.9	2.0	2.4	1.0	0.3	0.2
Cyclically-adjusted balance ⁵	-3.3	-2.3	-1.9	-2.4	:	:	:	:
Gross government debt ⁵	110.6	107.9	106.2	106.0	62.1	61.6	63.2	63.5
Employment								
Employment rate ⁷	54.8	55.5	56.1	:	62.8	62.9	63.0	:
Female employment rate ⁸	41.1	42	42.7	:	54.3	54.7	55.1	:
Employment rate for older workers ⁹	28	28.9	30.3	:	37.4	38.8	40.2	:
Long-term unemployment ¹⁰	5.8	5.3	4.9	:	3.8	3.9	4.0	:
Tax rate on low wage earners ¹¹	42.8	42.6	41.3	:	37.2	37.1	37.4	:
Unemployment trap indicator ¹²	59.6	59.9	58.2	:	78.8	78.5	78.3	:
Product market reforms								
Hourly labour productivity ¹³	106.3	102.7	101.1	:	:	:	:	:
Total trade to GDP ratio ¹⁴	27.0	25.9	24.5	:	30.1	29.2	28.7	:
Internal Market Directives ¹⁵	98.3	97.4	97.0	95.3	:	:	:	96.3
Business investment ¹⁶	17.3	17.9	16.5	:	17.9	17.2	16.8	:
Knowledge-based economy								
Total tertiary graduates ¹⁷	27.4	:	:	:	46.8	:	:	:
Spending on human resources ¹⁸	5.0	4.8	:	:	5.1	:	:	:
R&D expenditure ¹⁹	1.1	1.2	:	:	1.9	1.9	:	:
Expenditure on IT ²⁰	2.1	2.0	1.9	1.8	3.1	2.9	2.9	2.9

¹ Growth rate in percentage.

² Annual average rate of change in harmonised index of consumer prices in percentage.

³ Growth rate of real GDP per occupied person in percentage.

⁴ Growth rate of compensation per employee.

⁵ As a percentage of GDP.

⁶ Number of unemployed as a percentage of the labour force.

⁷ Employed persons aged 15-64 as a share of the total population of the same age group.

⁸ Employed women aged 15-64 as a share of the total female population of the same age group.

⁹ Employed persons aged 55-64 as a share of the total population of the same age group.

¹⁰ Long-term unemployed (over 12 months) as a percentage of the total active population aged 15-64.

¹¹ Income tax plus employer/employee contributions as a percentage of labour costs of a single earner at 67% of the Average Production Worker-wage, no children.

¹² Effective tax rate on labour income taking into account the combined effect of increased taxes and benefits withdrawal as an individual moves from unemployment back to work earning 67% of the Average Production Worker-wage, measured at the first month of unemployment (after any 'waiting period' if applicable).

¹³ GDP per hour worked in PPS, EU-15=100.

¹⁴ Percentage, average value of imports and exports of goods and services divided by GDP, multiplied by 100. For DE, ES, FR, IT, PL and the UK the value for EU-25 is the total for the large Member States, for all the other states the value for EU-25 is the total for the small Member States.

¹⁵ Percentage implemented in November 2004.

¹⁶ Gross fixed capital formation by the private sector as a percentage of GDP.

¹⁷ Total tertiary graduates (ISCED 5-6) per 1000 of population aged 20-29.

¹⁸ Public expenditure on education as a percentage of GDP.

¹⁹ GERD Gross domestic expenditure on R&D as a percentage of GDP.

²⁰ Expenditure on information technology as a percentage of GDP.

Source: Commission services (incl. Eurostat, structural indicators)

The data for 'general economic background' and 'public finance' are taken from the Commission's Autumn 2004 Economic Forecasts.

11. CYPRUS

Introduction

As the unfavourable external environment continued to negatively affect tourism, a mainstay of the economy, real GDP growth in 2003 remained unchanged with respect to 2002, reaching 2 per cent. Economic activity was mainly driven by domestic demand, notably in investment and government expenditure. For 2004 the estimation is for a modest rebound in real GDP growth to 3.5 per cent, further projected to strengthen to about 4 per cent for 2005 and 2006 and thereby bringing growth closer to with potential output growth. The recovery remains mostly domestic-demand led, although external demand is also projected to accelerate somewhat. On fiscal policy, the same factors that had led to an increase in the general government deficit in 2002 -an adverse external environment with lower GDP growth, increased government spending to offset lower growth plus revenue shortfalls- entailed a widening of the deficit in 2003 to 6.4 per cent of GDP, which thereby became the main challenge for economic policy. Consequently, fiscal policy in 2004 has mainly focused on reducing the government budget deficit in order to reach the convergence programme target of 5.2 per cent of GDP. Cyprus has the second highest level of productivity per person employed among the newly acceding Member States but productivity growth was relatively slow compared to the new Member States. The level of R&D expenditure and the share financed by industry are the lowest in the EU. In addition, although increasing, the use of ICT is quite limited. Finally, the Cypriot economy is dominated by small family enterprises and competition in network industries is still insufficient. A detailed assessment of recent developments in addressing Cyprus's key policy challenges is presented in the following sections.

1. Public finances

Ensure a reduction of the general government deficit on a sustainable basis

Under this challenge, Cyprus was requested to:

1. reduce the general government deficit in a credible and sustainable way within a multi-annual framework in line with the decisions to be taken by the Council in the context of the forthcoming budgetary surveillance exercise (GL1).

Fiscal consolidation efforts under way

On 5 July 2004, the Council decided that Cyprus was in excessive deficit and recommended that this be corrected by 2005 at the latest. Specifically, Cyprus was required to take effective action by 5 November 2004 in order to bring the deficit below 3 per cent of GDP in 2005. In addition, the Cypriot authorities are to ensure that the rise in the debt ratio, which (at 70.9 per cent of GDP in 2003) exceeds the 60 per cent of GDP reference value, is brought to a halt in 2004 and reversed thereafter.

For 2004 the convergence programme set a deficit target at 5.2 per cent of GDP. Government revenues in the period Jan-September increased by 11.3 per cent and expenditure decreased by 1.6 per cent compared to the same period last year. However, a significant proportion of expenditures usually takes place at the end of the year, while there also have been delays in introducing some of the 2004 fiscal measures on the revenue side, while there appear to be some uncertainties for now around the implementation of some of the measures for 2004 and 2005. Nevertheless, developments in government finance and fiscal consolidation measures taken have on the whole been encouraging so far for 2004 and the Commission services autumn 2004 forecast expects that the 2004 deficit target will be

met. The 2005 budget submitted to parliament in September 2004 follows the outline and measures provided in the convergence programme with a budget deficit target of 2.9 per cent of GDP, which constitutes a challenging objective. The Commission services here project a somewhat higher deficit (3.0 per cent of GDP) due to the slightly lower GDP growth forecast, linked to higher oil prices and lower prediction on a tourism rebound, both vulnerable areas for Cyprus. At the same time, the debt is projected to inch lower from an estimated 72.6 per cent of GDP in 2004 to 72.4 per cent of GDP in 2005.¹

2. Productivity and business dynamism

Increase the diversification of the economy towards higher value added activities

Under this challenge, Cyprus was requested to:

2. step up efforts to increase the adequacy of skilled human capital, promote R&D and innovation, in particular in the business sector, and improve conditions to facilitate ICT diffusion (GL 9, 13); and
3. continue to simplify the business and taxation environment (GL 11).

Several initiatives were launched to encourage the transition towards a knowledge based society.

Several initiatives were launched in 2004 to improve the adequacy of skilled human capital and to promote R&D, innovation and ICT diffusion. First, measures towards the development of information technology in schooling were taken to upgrade human capital. Both the number of computers and connections to internet in primary and secondary schools increased noticeably in 2004. Second, the funds allocated to R&D via the Framework Programme of the Research Promotion Foundation have for example been increased by around 30%. Third, the preparation of a national strategy for the development of information society which in particular included the implementation of e-Government services and new legislations in the field of e-commerce was completed.

Efforts have been made to simplify the business and taxation environment.

Measures to simplify the administrative burden for businesses were taken notably through the implementation of e-government services. In July 2004, a scheme aiming at supporting youth entrepreneurship in the manufacturing sector, and e-commerce as well as activities related to services in tourism was also initiated. As far as taxation was concerned, Cyprus complied with the VAT and excise duty rates prescribed by the *acquis communautaire*. It thereby shifted the tax burden from direct to indirect taxation with the aim to create a better business climate. Finally, efforts were made to reduce entry barriers in the telecommunication, electricity and air transport sectors.

¹ In November 2004, the Statistical Service produced a revision of National Accounts for the period 1995-2003 in the context of adopting ESA95. This brought small across-the-board upward revisions of nominal GDP of 1.5-3.9% for the period 1995-2003. In addition, some further minor revisions in the expected debt ratio for 2004 were introduced. In total, this led to marginal downward corrections of the government deficit by an average of around 0.1 percentage point of GDP, and lower debt ratios by an average of nearly 2 percentage points.

Table 11.1: Economic indicators for Cyprus

	Cyprus				EU-25			
	2001	2002	2003	2004	2001	2002	2003	2004
General economic background								
Real GDP growth ¹	4.0	2.0	2.0	3.5	1.8	1.1	1.0	2.5
Inflation ²	2.0	2.8	4.0	2.4	2.5	2.1	1.9	2.2
Labour productivity growth ³	1.9	0.8	1.1	2.4	0.8	0.9	0.9	2.1
Employment growth ¹	1.9	1.4	0.9	1.1	1.0	0.3	0.3	0.4
Nominal wage growth ⁴	4.7	4.4	4.9	4.0	4.0	3.2	3.1	3.0
Current account ⁵	-4.0	:	-3.5	-4.5	:	:	:	:
Unemployment ⁶	4.4	3.9	4.4	4.2	8.5	8.9	9.1	9.1
Public finance								
General government balance ⁵	-2.4	-4.6	-6.4	-5.2	-1.2	-2.3	-2.8	-2.8
Primary balance ⁵	1.2	-1.3	-2.9	-1.8	2.4	1.0	0.3	0.2
Cyclically-adjusted balance ⁵	:	:	:	:	:	:	:	:
Gross government debt ⁵	64.3	67.4	70.9	72.6	62.1	61.6	63.2	63.5
Employment								
Employment rate ⁷	67.8	68.6	69.2	:	62.8	62.9	63.0	:
Female employment rate ⁸	57.2	59.1	60.4	:	54.3	54.7	55.1	:
Employment rate for older workers ⁹	49.1	49.4	50.4	:	37.4	38.8	40.2	:
Long-term unemployment ¹⁰	0.9	0.8	1.1	:	3.8	3.9	4.0	:
Tax rate on low wage earners ¹¹	17	17.3	18.6	:	37.2	37.1	37.4	:
Unemployment trap indicator ¹²	52.9	54.8	53.7	:	78.8	78.5	78.3	:
Product market reforms								
Hourly labour productivity ¹³	:	:	:	:	:	:	:	:
Total trade to GDP ratio ¹⁴	57.5	53.3	48.8	:	:	58.8	57.2	:
Internal Market Directives ¹⁵	:	:	:	95.6	:	:	:	96.3
Business investment ¹⁶	14.6	15.8	14.1	:	17.9	17.2	16.8	:
Knowledge-based economy								
Total tertiary graduates ¹⁷	28.2	:	:	:	46.8	:	:	:
Spending on human resources ¹⁸	6.3	6.8	:	:	5.1	:	:	:
R&D expenditure ¹⁹	0.3	0.3	0.3	:	1.9	1.9	:	:
Expenditure on IT ²⁰	:	:	:	:	3.1	2.9	2.9	2.9

¹ Growth rate in percentage.

² Annual average rate of change in harmonised index of consumer prices in percentage.

³ Growth rate of real GDP per occupied person in percentage.

⁴ Growth rate of compensation per employee.

⁵ As a percentage of GDP.

⁶ Number of unemployed as a percentage of the labour force.

⁷ Employed persons aged 15-64 as a share of the total population of the same age group.

⁸ Employed women aged 15-64 as a share of the total female population of the same age group.

⁹ Employed persons aged 55-64 as a share of the total population of the same age group.

¹⁰ Long-term unemployed (over 12 months) as a percentage of the total active population aged 15-64.

¹¹ Income tax plus employer/employee contributions as a percentage of labour costs of a single earner at 67% of the Average Production Worker-wage, no children.

¹² Effective tax rate on labour income taking into account the combined effect of increased taxes and benefits withdrawal as an individual moves from unemployment back to work earning 67% of the Average Production Worker-wage, measured at the first month of unemployment (after any 'waiting period' if applicable).

¹³ GDP per hour worked in PPS, EU-15=100.

¹⁴ Percentage, average value of imports and exports of goods and services divided by GDP, multiplied by 100. For DE, ES, FR, IT, PL and the UK the value for EU-25 is the total for the large Member States, for all the other states the value for EU-25 is the total for the small Member States.

¹⁵ Percentage implemented in November 2004

¹⁶ Gross fixed capital formation by the private sector as a percentage of GDP.

¹⁷ Total tertiary graduates (ISCED 5-6) per 1000 of population aged 20-29.

¹⁸ Public expenditure on education as a percentage of GDP.

¹⁹ GERD Gross domestic expenditure on R&D as a percentage of GDP.

²⁰ Expenditure on information technology as a percentage of GDP.

Source: Commission services (incl. Eurostat, structural indicators)

The data for 'general economic background' and 'public finance' are taken from the Commission's Autumn 2004 Economic Forecasts.

12. LATVIA

Introduction

After an impressive 7.5 per cent growth achieved in 2003, Latvia's real GDP is estimated to have expanded a further 7.5 per cent in 2004. Private consumption and gross fixed capital formation have been the driving factors for growth. Strong private consumption has been supported by employment growth, rising real wages and increased bank lending. Gross fixed capital formation has remained buoyant as a result of favourable credit conditions and reinforced macroeconomic stability. Exports have grown strongly; however, imports have grown even more quickly, widening the already large external deficit. Inflation accelerated by almost four percentage points to 6.8 per cent year-on-year in 2004, but is expected to fall back to a little over 3½ per cent in 2006. Against this background the apparently pro-cyclical fiscal stance is of major concern. Despite significantly higher-than-expected growth of revenues in 2004, the estimated general government budget deficit remains at the originally targeted 2.0 per cent of GDP, since expenditure-increasing amendments to the budget of about 1 per cent of GDP were approved by the Latvian Parliament in August 2004. Another concern is that in spite of a strong growth performance, and sizeable employment gains since 2001, the unemployment rate remains at around 10 per cent of the labour force and is expected to drop only slightly in the medium term. Moderate employment gains will contribute to the decline, although considerable regional development disparities will hold back a faster improvement in labour market conditions. Starting from very low levels, Latvia's growth rates of labour productivity per person employed and GDP per capita have been amongst the highest in the EU in the past years. The economy is increasingly integrated in European markets and the level and growth of business investment are above the EU-average. Despite accelerating reforms, however, Latvian network industries suffer from a lack of effective competition and international connections. In addition, the level of R&D and innovation activities is still low and the reforms in the education system still need to focus on key problems such as a lack of responsiveness to labour market needs. A detailed assessment of recent developments in addressing Latvia's key policy challenges is presented in the following sections.

1. Public finances

Address the sizable current account deficit, to which an appropriate fiscal policy should contribute

Under this challenge, Latvia was requested to:

1. reduce the general government deficit in a credible and sustainable way within a multi-annual framework in line with decisions to be taken by the Council in the context of the forthcoming budgetary surveillance exercise (GL 1 and 2).

Following a period of uncertainty, the new 2005 draft budget is a step forward...

On 5 July 2004, the Council recommended, in its examination of Latvia's first convergence programme, that if the growth rates envisaged in the programme materialised Latvia should make progress towards a close-to-balance budgetary position, particularly in view of the current account deficit and domestic demand pressures. The policy stance adopted by the Latvian authorities in the August 2004 budget amendments seems to have disregarded these guidelines. The deficit target for 2004 remained unchanged at 2.0 per cent of GDP, whereas growth of output and of revenues in 2004 were significantly higher than foreseen in the convergence programme (GDP growth is now estimated at 7.5 per cent instead of 6.7 per cent assumed by the macroeconomic scenario of the convergence programme) which in the circumstances should have led to the target deficit being tightened.

However, on 11 December the government approved new amendments to the 2004 budget setting the deficit target at 1.9 per cent of GDP. The December amendments foresee increase in both expenditure and revenues. On the expenditure side these include a number of one-off payments previously intended for the next year, such as direct payment to farmers, contributions to the EU 2005 budget and advancing of financing for some development and structural projects. At the same time tax revenue forecasts have been raised in the light of much higher outturns. The draft 2005 budget law adopted by the government in September marked a shift towards a more expansionary fiscal policy. The draft 2005 budget law foresaw consolidated budget revenues to increase by 23.5 per cent and expenditure by 21.5 per cent, both compared to the 2004 budget execution after taking into account the August 2004 amendments. At the same time the authorities voiced their commitment to respect the 2.2 per cent of GDP deficit target set in the May convergence programme. However, this draft 2005 budget was rejected in Parliament during its first reading on 28 October. The rejection of the budget caused the government to resign. A new government was approved on 2 December and has submitted to the Parliament a new draft 2005 budget which envisages the reduction of the deficit to 1.7% of GDP. Although the new draft budget is not free of downside risks, mostly stemming from the rather optimistic forecasts of tax revenues, it marks some progress towards a close-to-balance budgetary position.

2. Productivity and business dynamism

Improve conditions for increasing productivity

Under this challenge, Latvia was requested to:

2. increase the efficiency, quality and accessibility of the education and training systems, and their responsiveness to the labour markets' needs (GL 13 and 14);
3. encourage R&D and innovation, in particular in the business sector (GL 13 and 14); and
4. encourage an entrepreneurial culture (GL 11).

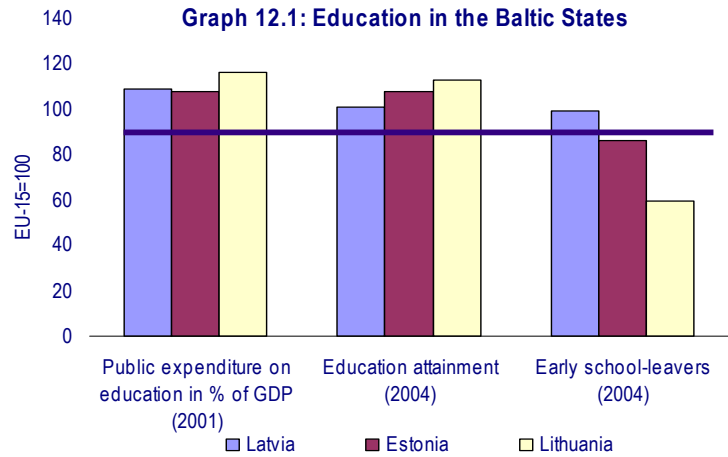
Actions have been taken to improve the education system, albeit without focusing on the key problems...

Reforming the educational system to transform Latvia into a knowledge-based economy is a priority for the authorities and this goal has been translated into a multi-annual plan. The reform of basic education has been completed with increased decentralisation of decision-making and the reforms of secondary and tertiary education are ongoing. As a healthy sign, private universities are developing and new tax incentives should help families and companies to support the cost of education. The ratio of tertiary students to population is one of the highest in Europe. Nevertheless, the education system lacks financing to provide adequate remuneration of the teaching staff, to update programmes and teaching techniques and to maintain the infrastructure. In addition, there is a lack of responsiveness of the education system to labour market needs. In particular, the system of scholarships may put too much emphasis on studies for which student demand is high rather than branches where there is a shortage of specialists in the labour market.

... whilst plans to promote R&D and innovation have been launched...

At around 0.4 per cent, the ratio of R&D expenditure to GDP is amongst the lowest of the EU-25. In addition, the share financed by industry is low, with approximately 80 per cent coming from public and foreign sources in 2002. Latvia has taken action through its national innovation programme to promote R&D and innovation, to support the development of new technologies and to increase cooperation between research and business. Notably, the innovation system has been streamlined and financial support through risk capital and grants

is increasingly available. Further actions are planned based on the additional possibilities offered by EU structural funds.



... and measures have been taken to develop an entrepreneurial culture.

Latvia has one of the lowest levels of business creation in the EU, despite an impressive level of business investment. The main barriers to entrepreneurship are administrative, financial and cultural. The authorities have issued guidelines to promote the development of SMEs and have further reduced the corporate tax rate to 15 per cent. To promote access to capital by Latvian SMEs and to encourage commercial banks to offer loans to entrepreneurs, the authorities have issued State guarantees through various ad hoc financial and credit institutions. In addition, Latvia has established a so-called Business Environment Simplification Task, which inter alia evaluates policies towards entrepreneurship and identifies best practices in this field. Results have been achieved in lessening the administrative burden but the multiplicity of administrative requirements stemming from various levels of authorities remains a problem for businesses.

3. Labour market

Address the structural problems in the labour market

Under this challenge, Latvia was requested to:

5. revise the tax and benefit system in order to make work pay more, in particular by increasing the efficiency of social spending (GL 4); and
6. 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, especially through improvements in transport infrastructure (GL 7 and 13).

Encouraging measures to make work pay

Even though the flat rate income tax of 25 percent and the 33 percent total rate of social security contributions can be considered average in comparison with the tax rates on labour in other EU countries, the labour tax wedge is very high in Latvia. This is due to low wages and very small provision for tax-free income. Thus, job creation is restricted and undeclared work, often taking the form of undeclared cash payments for part of an employee's work, is common. The government has prepared a plan for 2005-2009 to diminish undeclared work, which foresees measures for increasing the administrative and regulatory capacity of the State Labour Inspectorate, improving cooperation of the regulatory institutions and the dissemination of information about the labour law. Furthermore, the State Revenues Service has developed its own action plan to combat undeclared work. This plan combines intensification of monitoring at the workplace and strengthening cooperation with other

public and municipal institutions. Since in Latvia the total rate of health and social security contributions is 33 per cent of gross wages, and the income tax rate is 25 per cent, the labour tax wedge is very high. Thus, job creation is restricted and undeclared work, often taking the form of undeclared cash payments for part of an employee's work, is common. The government has prepared an action plan for 2005-2009 to combat undeclared work. This plan combines intensification of control and monitoring at the workplace, an increase in the resources of the State Labour Inspectorate, and dissemination of information about the labour law. A newly introduced contribution-based second pension pillar may increase incentives to report wages.

Recent changes in the tax and social security system with effect from 2005 may contribute to a higher motivation to enter the labour market. Most notably, the schedule adopted in 2003 by the Latvian government after lengthy discussions with the social partners provides for a gradual annual increase over a six-year period of the minimum wage from EUR 120 per month in 2004 to EUR 210 by 2010. The government has also approved a plan for raising the tax-free threshold over a six-year period, starting from 2005, to EUR 105, or half of the minimum wage as it will then stand. The tax-free threshold currently stands at EUR 32 per month. The proposal also provides for setting income tax rebates for dependents at half of the minimum tax-free threshold. However, despite these efforts, more needs to be done to ensure the efficiency of social spending.

Limited labour mobility with important elements of the reform still pending.

Latvia has one of the highest unemployment rates in the EU (10.5 per cent in 2003). This is accompanied by a relatively low employment rate (61.8 per cent for the 15-64 year age-bracket for 2003). Despite a steady decline in unemployment and sizable increase in employment rates achieved in recent years, the large share of underutilised resources and the lower level of labour productivity in the eastern regions of Latvia continue to be key challenges. In 2002, the latest year for which final regional data is available, GDP per capita in Riga was at 182 per cent of the national average, while it reached only 37 per cent of the average in the eastern regions of the country. Low regional mobility is one factor, with transportation and housing policy as the main obstacles. Commuting of the workforce is restricted by the deficiencies of the transport infrastructure at both intra- and inter-regional levels and difficulties in accessing the less-developed regions. The development of the motorway network and public transportation, which is a key priority of the Latvian authorities in the medium term², should improve the accessibility of the eastern regions of the country and thus might contribute towards job creation in these areas. However, there remains the risk that insufficient emphasis is put on the construction, upgrading and capacity enhancement of smaller roads in regions with high unemployment. A strongly underdeveloped market for rented accommodation and significant regional differences in real estate prices limit the opportunities for domestic migration. In general, a lack of co-ordination among the public institutions concerned regarding mobility-improving measures is of concern. As a consequence, it seems uncertain whether the new measures will sufficiently take into account the characteristics of the targeted groups, and whether these will be sufficient to increase significantly the mobility of the workforce.

The Latvian authorities in consultation with social partners have prepared a National Action Plan for Employment 2004, which builds on experience of the four previous employment strategy declarations announced since 2000. Actions taken within a plan framework combine active labour market policies, including occupational training, retraining and raising of qualifications (similar actions in 2003 resulted in 51.9 per cent of 5049 targeted unemployed persons finding a new job); measures of competitiveness and measures for specified groups

² On September 28, 2004 the Cabinet of Ministers accepted the Basic Guidelines for Development of Public Transport 2005-2014. This document outlines policy for domestic public transport for the next 10 years.

such as the elderly, youth and the disabled unemployed. While progress is being made, strengthening 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 remains a key challenge in Latvia, as there is a limited capacity to respond to the demands for high skilled labour and significant and persistent differences in employment across the regions.

4. Competition in network industries

Develop effective competition in network industries

Under this challenge, Latvia was requested to:

7. take legal measures to enhance effective competition in network industries and to strengthen the role of the regulator (GL 9); and
8. increase physical interconnections with other European networks (GL 9).

Reforms to liberalise network industries have been of a different intensity across sectors...

Although all non-household users in practice have had access to the liberalised segment of the electricity market since July 2004, Latvia has not yet transposed EU electricity and gas directives. The current law states that the incumbent is indivisible. A draft law is being prepared that should integrate universal service obligations and solve the current lack of unbundling and third party access. This new law should come into force by March 2005. The gas market depends largely on third party access in Russia and the effective competition in energy markets remains generally low. In telecommunications, postal services and railways, regulatory changes have been made to comply with the latest EU legislation. Competition is developing in telecommunications with a decreasing market share for the incumbent and the unbundling of the local loop. In terms of regulation, the fines that can be imposed by the Public Utility Commission appear too low to constitute a credible threat. Latvia is also considering moving to a one-tier state-level regulation for network industries instead of the current two-tier state- and local-level system.

... and projects are starting to improve interconnection capacities.

As a legacy from the past, Baltic Countries railway interconnections are not well developed with other EU neighbouring countries. The creation of a modern and high-speed interconnection between the Baltic States and Poland has been set as a priority and approved in the list of projects adopted in the Trans-European Transport Network Guidelines. Efforts are also being made to create a common Baltic electricity market and projects to connect the electricity network with those of Poland and Finland have been studied. The interconnection with Finland is progressing as a consortium has been set up to finance the needed investment.

Table 12.1: Economic indicators for Latvia

	Latvia				EU-25			
	2001	2002	2003	2004	2001	2002	2003	2004
General economic background								
Real GDP growth ¹	8.0	6.4	7.5	7.5	1.8	1.1	1.0	2.5
Inflation ²	2.5	2.0	2.9	6.8	2.5	2.1	1.9	2.2
Labour productivity growth ³	5.7	4.8	5.6	6.7	0.8	0.9	0.9	2.1
Employment growth ¹	2.2	1.6	1.7	0.8	1.0	0.3	0.3	0.4
Nominal wage growth ⁴	3.4	4.4	10.8	14.0	4.0	3.2	3.1	3.0
Current account ⁵	-8.9	-7.0	-8.6	-9.9	:	:	:	:
Unemployment ⁶	12.9	12.6	10.5	9.9	8.5	8.9	9.1	9.1
Public finance								
General government balance ⁵	-2.1	-2.7	-1.5	-2.0	-1.2	-2.3	-2.8	-2.8
Primary balance ⁵	-1.1	-1.9	-0.7	-1.2	2.4	1.0	0.3	0.2
Cyclically-adjusted balance ⁵	:	:	:	:	:	:	:	:
Gross government debt ⁵	14.9	14.1	14.4	14.6	62.1	61.6	63.2	63.5
Employment								
Employment rate ⁷	58.6	60.4	61.8	:	62.8	62.9	63.0	:
Female employment rate ⁸	55.7	56.8	57.9	:	54.3	54.7	55.1	:
Employment rate for older workers ⁹	36.9	41.7	44.1	:	37.4	38.8	40.2	:
Long-term unemployment ¹⁰	7.2	5.7	4.3	:	3.8	3.9	4.0	:
Tax rate on low wage earners ¹¹	41.2	41.4	40.8	:	37.2	37.1	37.4	:
Unemployment trap indicator ¹²	85.8	86.2	86.6	:	78.8	78.5	78.3	:
Product market reforms								
Hourly labour productivity ¹³	:	:	:	:	:	:	:	:
Total trade to GDP ratio ¹⁴	46.7	46.1	48.7	:	:	58.8	57.2	:
Internal Market Directives ¹⁵	:	:	:	93.3	:	:	:	96.3
Business investment ¹⁶	24.0	22.8	22.9	:	17.9	17.2	16.8	:
Knowledge-based economy								
Total tertiary graduates ¹⁷	62.6	58.5	:	:	46.8	:	:	:
Spending on human resources ¹⁸	5.8	5.8	:	:	5.1	:	:	:
R&D expenditure ¹⁹	0.4	0.4	0.4	:	1.9	1.9	:	:
Expenditure on IT ²⁰	1.9	2.1	2.5	2.5	3.1	2.9	2.9	2.9

¹ Growth rate in percentage.

² Annual average rate of change in harmonised index of consumer prices in percentage.

³ Growth rate of real GDP per occupied person in percentage.

⁴ Growth rate of compensation per employee.

⁵ As a percentage of GDP.

⁶ Number of unemployed as a percentage of the labour force.

⁷ Employed persons aged 15-64 as a share of the total population of the same age group.

⁸ Employed women aged 15-64 as a share of the total female population of the same age group.

⁹ Employed persons aged 55-64 as a share of the total population of the same age group.

¹⁰ Long-term unemployed (over 12 months) as a percentage of the total active population aged 15-64.

¹¹ Income tax plus employer/employee contributions as a percentage of labour costs of a single earner at 67% of the Average Production Worker-wage, no children.

¹² Effective tax rate on labour income taking into account the combined effect of increased taxes and benefits withdrawal as an individual moves from unemployment back to work earning 67% of the Average Production Worker-wage, measured at the first month of unemployment (after any 'waiting period' if applicable).

¹³ GDP per hour worked in PPS, EU-15=100.

¹⁴ Percentage, average value of imports and exports of goods and services divided by GDP, multiplied by 100. For DE, ES, FR, IT, PL and the UK the value for EU-25 is the total for the large Member States, for all the other states the value for EU-25 is the total for the small Member States.

¹⁵ Percentage implemented in November 2004.

¹⁶ Gross fixed capital formation by the private sector as a percentage of GDP.

¹⁷ Total tertiary graduates (ISCED 5-6) per 1000 of population aged 20-29.

¹⁸ Public expenditure on education as a percentage of GDP.

¹⁹ GERD Gross domestic expenditure on R&D as a percentage of GDP.

²⁰ Expenditure on information technology as a percentage of GDP.

Source: Commission services (incl. Eurostat, structural indicators)

The data for 'general economic background' and 'public finance' are taken from the Commission's Autumn 2004 Economic Forecasts.

13. LITHUANIA

Introduction

After growing rapidly at 9.7 per cent in 2003, real output is projected to expand by 6.5 per cent on average over the period 2004-2006. Growth is foreseen to remain primarily sustained by strong investment and private consumption. Starting from very low levels, Lithuania's growth rates of labour productivity per person employed and GDP per capita have been amongst the highest in the EU in the past years. The trend of falling prices initiated in 2002 reversed in 2004, when annual average inflation is estimated to reach 1.2 per cent. Inflation is expected to accelerate further in 2005-2006. The fiscal and external balances deteriorated significantly in 2004, and avoiding pro-cyclical policies is a key challenge. Major reform efforts were concentrated on the promotion of active labour market policies, to attract more people to the labour market especially at a disadvantage, as well as on developing competition in network industries. The transposition rate of Internal Market directives is among the best in the EU and Lithuania updated its competition and network industries legislation. Lithuania ranks among the economies with the best business climate. However, despite progress, reform efforts will have to be sustained to improve the conditions for increasing productivity and to develop effective competition in network industries. A detailed assessment of recent developments in addressing Lithuania's key policy challenges is presented in the following sections.

1. Labour market

Address the structural problems in the labour market

Under this challenge, Lithuania was requested to:

1. enhance regional mobility and reduce skill mismatches, whilst ensuring the efficiency of education, retraining measures and other active labour market policies (GL 4, 7 and 8); and
2. improve the combined incentive effects of taxes and benefits (GL 4).

Structural problems in the labour market are being addressed

Several measures under implementation should contribute to improving regional mobility in the medium term. Progress is being made as regards infrastructure development. In particular, new programmes are being implemented for reconstruction of passenger terminals and access infrastructure, road paving and improving the quality of public transport, for which cohesion and structural funds have been assigned. Those measures are expected to improve mobility, particularly in rural and remote areas. New measures aimed at reducing skill mismatches were taken in 2004 and should contribute to better meeting the rapidly growing demand for labour in the private sector. A new government resolution approved in May 2004 introduced measures aimed at promoting employers' investment in vocational training and the employees' qualifications, also allocating structural funds to co-finance these activities. The government is also preparing for the impact of the decommissioning of the Ignalina nuclear power plant, which is perceived as a major regional challenge. Actions taken consist in strengthening of administrative structure for addressing the region's problems: development agency and business incubator, business competence center; the preparation of active labour market policies, including regional training offices in the area and improvement of secondary legislation (procedures of preparation of personalised action plans of employees, procedures of payment of additional severance pays, pre-retirement unemployment benefits, movement allowances) while preparing for the impact of potential sizeable lay-offs. While progress is being made, improving the quality of the labour force and increasing access and efficiency of the education system remain key challenges in Lithuania.

More emphasis will be devoted to the combined incentive effects of taxes and benefits

Discussions on labour taxation and work incentives involving the government, the central bank and different social partners have been going on in the course of 2004 but no major decisions have been taken yet. New measures to alleviate labour taxation and to improve incentives to work are expected to be adopted soon, as there was a general perception that decisions were delayed due to the parliamentary elections held in October 2004. Measures under preparation should improve incentives to work for several inactive groups of the population and contribute to increasing labour supply. Before the end of 2004, draft legislation on the conditions of paternity leave and new measures to improve incentives for elderly women to work are expected. Looking ahead, the unemployment insurance system will be overhauled in 2005. The new legislation links the unemployment benefits to earned wages and establishes new criteria for receiving benefits. The financing system of unemployment benefits should become more transparent, using unemployment insurance funds to finance only unemployment benefits, while labour market institutions and active labour market policies will be financed by the state budget.

2. Public finances

Maintain low general government deficits

Under this challenge, Lithuania was requested to:

3. pursue low budget deficits in a credible and sustainable way within a multi-annual framework in line with the decisions to be taken by the Council in the context of the forthcoming budgetary surveillance exercise (GL 1); and
4. avoid pro-cyclical fiscal policies that prevent a further reduction of the general government deficit, in particular by avoiding budget amendments that allocate additional expenditure in response to higher than expected revenues (GL 2).

The general government deficit in 2004 is likely to be better than planned

On 5 July 2004, the Council recommended, in its examination of Lithuania's first convergence programme, to make further progress towards a close-to-balance budgetary position if the growth rates envisaged in the programme materialise, particularly in view of current account deficit and domestic demand pressures. Lithuania was also encouraged to implement strictly the budget to reduce the risk of breaching the 3 per cent of GDP reference value in 2004, and to use better-than-projected revenues for deficit reduction. The general government deficit increased from 1.9 per cent of GDP in 2003 to 2.6 per cent in 2004 (compared to the 2.7 per cent target in the convergence programme). The government's deficit target for 2005 is 2.5 per cent of GDP. Avoiding a more pro-cyclical stance in 2005 is regarded as a key challenge, particularly in view of the persisting pressures on domestic demand and the deterioration of current account deficit, which reached 9.7 per cent in the first half of 2004. Furthermore, the target does not leave a sufficient safety margin against the 3 per cent reference value if automatic stabilisers were to play freely in a strong cyclical relapse. Based on recent revenue developments and the budget for 2005, the targets are likely to be met.

No sizeable budget amendments have been implemented after 5 July

Since the adoption of the Council recommendations on 5 July, no major budget amendments were made. The Lithuanian authorities implemented two budget revisions in 2004. The first revision, approved in June, allocated significant additional expenditure on the back of higher-than-budgeted revenues and savings in debt service costs. The additional expenditure amounted to some 0.3 per cent of GDP and was primarily allocated to social benefits, civil

servant salaries, transfers to municipalities and savings restitutions. The second budget revision, approved by the government in August 2004, involved rather small amounts (about 0.03 per cent of GDP) and consisted on an increase of funds granted to political parties which was mostly financed by savings in public debt service costs. General government revenues increased more than expected in July-September 2004, and no further budget amendments were carried out.

3. Productivity and business dynamism

Improve conditions for increasing productivity

Under this challenge, Lithuania was requested to:

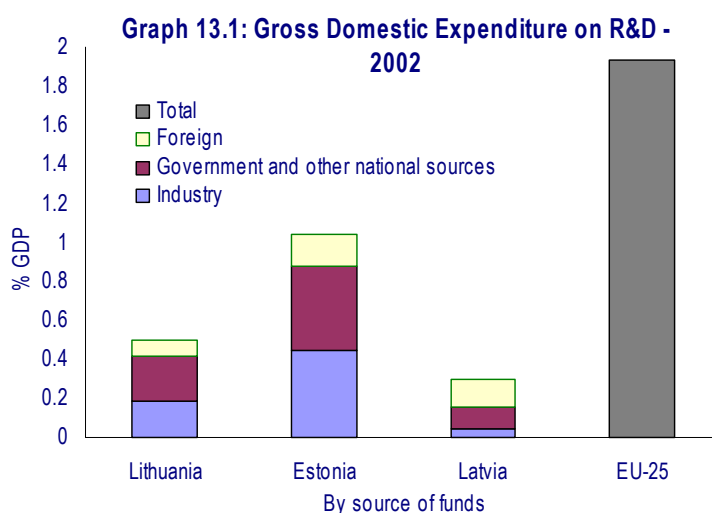
5. improve the efficiency and quality of the education and training systems and their responsiveness to labour market needs (GL 13); and
6. promote R&D and innovation, strengthen the links between research institutes and the business sector and support knowledge transfer through FDI and higher IT penetration (GL 13).

Actions have been taken to improve vocational training...

Over recent years, Lithuania has improved its youth education attainment level from 77.9 per cent in 2000 to 82.1 per cent in 2003. However, the system of vocational training is still deficient with a low participation rate and an inadequate responsiveness to labour market needs. In 2003, only 2.3 per cent of the population aged 35-59 and 8.6 per cent of the population aged 25-34 participated in education and training. Lithuania has started a lifelong learning strategy to remedy this situation with policy actions in terms of education infrastructure, accessibility, coordination of programmes, improvement and monitoring of quality. In particular, the accent is put on providing companies with incentives to invest in their human capital so as to match their specific needs. In addition, a new law on vocational education and training will be drafted in 2005.

... and to become a knowledge-based economy.

At around 0.7 per cent, the ratio of R&D expenditure to GDP is still far away from the EU-average. In addition, the share financed by the industry is low with over 60 per cent coming from public sources. Albeit increasing over the most recent period, the number of IT users in Lithuania is still relatively limited because of financial reasons and because of a lack of adequate infrastructure and



awareness. Lithuania has taken action to promote R&D and innovation, to support the development of new technologies and the use of IT, and to increase the cooperation between research and business, mainly through financial incentives and proactive coordination of programmes. Further actions are planned based on the additional possibilities offered by the

EU structural funds, notably to help Lithuanian investors to face the costs of international patenting.

4. Competition in network industries

Develop effective competition in network industries

Under this challenge, Lithuania was requested to:

7. pursue liberalisation and enforce effective competition in energy, telecommunications and railway markets (GL 9); and
8. create and improve interconnection capacities with neighbouring EU Member States (GL 9).

A set of reforms have been taken to further liberalise network industries...

In 2004, Lithuania has embarked on a set of reforms to further liberalise and enforce competition in network industries. In line with EU legislation, the electricity and gas markets for non-households users have been liberalised. Following liberalisation in 2003, the telecommunications market has experienced a rapid growth and dramatic cuts in prices of local and international calls from fixed lines. The introduction of number portability and the digitalisation of lines are further determinants of increased competition. Finally, in the framework of the 2003-2006 strategy to ensure the effective functioning of the railway sector and its integration in the EU network, Lithuania has passed a law to separate the management of the infrastructure from other operations. These reforms should help to promote effective competition in markets where incumbents still retain high market shares.

... and projects are starting to improve interconnection capacities.

As a legacy from the past, Lithuanian railway interconnections are not well developed with neighbouring EU countries. The creation of a modern and high-speed interconnection called Rail Baltica Project has been set as a priority and approved in the list of projects adopted in the Trans-European Transport Network Guidelines. Efforts are also being made to create a common Baltic electricity market and projects to connect the electricity network with those of Poland and Finland have been studied. Interconnections in air transport are developing as a result of liberalisation measures that increase the number of players and destinations, whilst several projects such as the Via Baltica should improve the road connections between the Baltic States.

Table 13.1: Economic indicators for Lithuania

	Lithuania				EU-25			
	2001	2002	2003	2004	2001	2002	2003	2004
General economic background								
Real GDP growth ¹	6.4	6.8	9.7	7.1	1.8	1.1	1.0	2.5
Inflation ²	1.3	0.4	-1.1	1.2	2.5	2.1	1.9	2.2
Labour productivity growth ³	10.0	2.7	7.2	5.5	0.8	0.9	0.9	2.1
Employment growth ¹	-3.3	4.0	2.3	1.6	1.0	0.3	0.3	0.4
Nominal wage growth ⁴	3.4	1.4	8.2	7.8	4.0	3.2	3.1	3.0
Current account ⁵	-4.7	-5.2	-6.9	-8.7	:	:	:	:
Unemployment ⁶	16.4	13.5	12.7	11.4	8.5	8.9	9.1	9.1
Public finance								
General government balance ⁵	-2.0	-1.5	-1.9	-2.6	-1.2	-2.3	-2.8	-2.8
Primary balance ⁵	-0.4	-0.1	-0.6	-1.4	2.4	1.0	0.3	0.2
Cyclically-adjusted balance ⁵	:	:	:	:	:	:	:	:
Gross government debt ⁵	22.9	22.4	21.4	21.1	62.1	61.6	63.2	63.5
Employment								
Employment rate ⁷	57.5	59.9	61.1	:	62.8	62.9	63.0	:
Female employment rate ⁸	56.2	57.2	58.4	:	54.3	54.7	55.1	:
Employment rate for older workers ⁹	38.9	41.6	44.7	:	37.4	38.8	40.2	:
Long-term unemployment ¹⁰	9.1	7.3	6.1	:	3.8	3.9	4.0	:
Tax rate on low wage earners ¹¹	42.2	41.3	39.5	:	37.2	37.1	37.4	:
Unemployment trap indicator ¹²	54.1	51.8	49.3	:	78.8	78.5	78.3	:
Product market reforms								
Hourly labour productivity ¹³	:	37.6	39.2	:	:	:	:	:
Total trade to GDP ratio ¹⁴	52.8	55.9	55.2	:	:	58.8	57.2	:
Internal Market Directives ¹⁵	:	:	:	99.6	:	:	:	96.3
Business investment ¹⁶	18.0	17.6	17.8	:	17.9	17.2	16.8	:
Knowledge-based economy								
Total tertiary graduates ¹⁷	57.7	63.0	:	:	46.8	:	:	:
Spending on human resources ¹⁸	5.9	5.9	:	:	5.1	:	:	:
R&D expenditure ¹⁹	0.7	0.7	0.7	:	1.9	1.9	:	:
Expenditure on IT ²⁰	1.5	1.5	1.6	1.6	3.1	2.9	2.9	2.9

¹ Growth rate in percentage.

² Annual average rate of change in harmonised index of consumer prices in percentage.

³ Growth rate of real GDP per occupied person in percentage.

⁴ Growth rate of compensation per employee.

⁵ As a percentage of GDP.

⁶ Number of unemployed as a percentage of the labour force.

⁷ Employed persons aged 15-64 as a share of the total population of the same age group.

⁸ Employed women aged 15-64 as a share of the total female population of the same age group.

⁹ Employed persons aged 55-64 as a share of the total population of the same age group.

¹⁰ Long-term unemployed (over 12 months) as a percentage of the total active population aged 15-64.

¹¹ Income tax plus employer/employee contributions as a percentage of labour costs of a single earner at 67% of the Average Production Worker-wage, no children.

¹² Effective tax rate on labour income taking into account the combined effect of increased taxes and benefits withdrawal as an individual moves from unemployment back to work earning 67% of the Average Production Worker-wage, measured at the first month of unemployment (after any 'waiting period' if applicable).

¹³ GDP per hour worked in PPS, EU-15=100.

¹⁴ Percentage, average value of imports and exports of goods and services divided by GDP, multiplied by 100. For DE, ES, FR, IT, PL and the UK the value for EU-25 is the total for the large Member States, for all the other states the value for EU-25 is the total for the small Member States.

¹⁵ Percentage implemented in November 2004.

¹⁶ Gross fixed capital formation by the private sector as a percentage of GDP.

¹⁷ Total tertiary graduates (ISCED 5-6) per 1000 of population aged 20-29.

¹⁸ Public expenditure on education as a percentage of GDP.

¹⁹ GERD Gross domestic expenditure on R&D as a percentage of GDP.

²⁰ Expenditure on information technology as a percentage of GDP.

Source: Commission services (incl. Eurostat, structural indicators)

The data for 'general economic background' and 'public finance' are taken from the Commission's Autumn 2004 Economic Forecasts.

14. LUXEMBOURG

Introduction

The Luxembourg economy performed rather well in recent years: real GDP growth still remained above the EU average in the past few years and is expected to have accelerated to around 4 per cent in 2004 slowing down only slightly. Even though these growth rates are significantly lower than the exceptional ones observed in the late 1990s (between 7 per cent and 9 per cent a year), they are much higher than those recorded in neighbouring countries. Similarly, employment growth kept posting positive growth rates albeit less impressive than in previous years. Faced with the possibility of weaker trend growth than in the past few decades, Luxembourg should attempt to increase the employment rate of its residents, which is low and even very low for workers above 55 years of age. The reforms underway aiming at improving the business environment, namely the modernisation of the competition law and the reduction of administrative burdens on businesses as well as the promotion of entrepreneurship, will contribute in the long term to reducing Luxembourg's excessive sectoral concentration of economic activity in banking services, business support and real estate services. The rate of transposition of Internal Market directives is still well below the target. A detailed assessment of recent developments in addressing Luxembourg's key policy challenges is presented in the following sections.

1. Labour market

Increase the low national participation and employment rates, especially for older workers	Assessment
Under this challenge, Luxembourg was requested to:	
1. review incentives for early and pre-retirement and ensure appropriate eligibility rules in the disability pension scheme (GL 16).	Limited
Bearing in mind the three-year period available for implementation, the degree of implementation since 2003 is indicated as: "Complete" for (practically) complete; "In progress" where progress is well advanced; "Limited" where the recommendation is only partially addressed and "Insufficient" where no substantial measures going in the right direction have been taken.	

Labour force participation remains low...

The massive job creation entailed by fast output growth in the last two decades has chiefly been met by an increasing recourse to cross-border workers, who represent nowadays more than one third of total employment and have accounted for two thirds of its rise since 1995. However, while the country increasingly plays the role of a major employment pool for residents of neighbouring regions, national participation and employment rates remain low, especially for old workers: Luxembourg has the lowest participation rate in the EU-15 for workers between 55 and 64, both for men and women. Moreover, the impressive employment growth in the last two decades will inevitably translate into a similar increase in the number of retirees in the coming years. The ratio between contributors and pensioners will thus necessarily deteriorate, unless employment growth, too, accelerates in the same proportion, which seems quite unlikely.

...and only partial action has been taken to reduce incentives to use disability or early retirement schemes and to encourage older workers to continue to work

As already stated in the 2004 Implementation Report, measures have been decided in 2002 and 2003 (especially the removal in December 2003 of the obligation of prior approval by

the administration when a pensioner starts a new activity) and some progress has been realised in reducing the inflow into the disability scheme and raising the effective retirement age. However, no additional measure seems to have been taken in 2004.

2. Productivity and business dynamism

Improve the business environment and encourage entrepreneurship in order to achieve a more balanced economic structure	Assessment
Under this challenge, Luxembourg was requested to:	
2. fully implement the reforms of competition law and to ensure that competition and regulatory authorities have sufficient independence, resources and power to fulfil their tasks (GL 9); and	In progress
3. take measures to encourage and facilitate the creation of SMEs and to help those to access venture capital (GL 11).	In progress

Reforms of the competition and regulatory framework have been finalised.

The modernisation of the legislative framework for competition policy was finalised in 2004. The introduction of the new competition law in May 2004 will eliminate the shortcomings of the existing body of legislation such as the regulation on fixed and monitored prices. Pharmaceuticals, taxis and fuels are the only exceptions to the principle of market based pricing. With this reform, an independent Competition Council was recently set up whose duties include supervising the application of the new national legislation and the enforcement of EU law where applicable. However, the ability of the new competition authority and of the *Institute Luxembourgeois de Régulation* (ILR), the market regulator for the electricity, gas, post, and telecommunications, to perform their tasks has still to be assessed. The resources of the latter have been gradually increasing; in December 2003 its total staff was 32 people (up from 29 in December 2002).

Efforts to encourage entrepreneurship have continued.

The implementation of initiatives to reduce the administrative burdens on businesses and on SMEs in particular has continued. New measures were announced such as the generalisation of audits of the effects of new legislation and regulation on the business environment, with particular emphasis on SMEs. However, Luxembourg is still one of the countries with the highest percentage of SMEs identifying administrative burdens as a major business constraint (8 per cent). In June 2004 a risk capital enterprise (SICAR) was launched to foster access to venture capital. It will contribute to improve business conditions for SMEs. The development of business entrepreneurship remains a concern of the government. In 2004 the action plan “Entrepreneurship au Luxembourg- *Entreprendre pour réussir*” was launched to coordinate all initiatives in the area. Activities with the direct involvement of schools, businesses and Chambers of Commerce as well as awareness campaigns are among the measures directed at the young that have continued to be implemented.

Table 14.1: Economic indicators for Luxembourg

	Luxembourg				EU-25			
	2001	2002	2003	2004	2001	2002	2003	2004
General economic background								
Real GDP growth ¹	1.5	2.5	2.9	4.0	1.8	1.1	1.0	2.5
Inflation ²	2.4	2.1	2.5	3.0	2.5	2.1	1.9	2.2
Labour productivity growth ³	-3.9	-0.5	1.1	1.9	0.8	0.9	0.9	2.1
Employment growth ¹	5.7	3.0	1.8	2.0	1.0	0.3	0.3	0.4
Nominal wage growth ⁴	3.9	3.7	2.1	3.3	4.0	3.2	3.1	3.0
Current account ⁵	5.5	5.9	5.3	4.4	:	:	:	:
Unemployment ⁶	2.1	2.8	3.7	4.3	8.5	8.9	9.1	9.1
Public finance								
General government balance ⁵	6.4	2.8	0.8	-0.8	-1.2	-2.3	-2.8	-2.8
Primary balance ⁵	6.7	3.0	1.0	-0.6	2.4	1.0	0.3	0.2
Cyclically-adjusted balance ⁵	5.2	2.9	1.7	0.4	:	:	:	:
Gross government debt ⁵	5.5	5.7	5.3	4.9	62.1	61.6	63.2	63.5
Employment								
Employment rate ⁷	63.1	63.4	62.7	:	62.8	62.9	63.0	:
Female employment rate ⁸	50.9	51.6	52	:	54.3	54.7	55.1	:
Employment rate for older workers ⁹	25.6	28.1	30	:	37.4	38.8	40.2	:
Long-term unemployment ¹⁰	0.6	0.8	0.9	:	3.8	3.9	4.0	:
Tax rate on low wage earners ¹¹	28.8	27.1	27.3	:	37.2	37.1	37.4	:
Unemployment trap indicator ¹²	87.6	86.7	86.8	:	78.8	78.5	78.3	:
Product market reforms								
Hourly labour productivity ¹³	131.1	126.7	127.1	:	:	:	:	:
Total trade to GDP ratio ¹⁴	:	127.1	122.9	:	:	58.8	57.2	:
Internal Market Directives ¹⁵	97.9	97.7	96.6	95.6	:	:	:	96.3
Business investment ¹⁶	18.6	17.2	15.0	:	17.9	17.2	16.8	:
Knowledge-based economy								
Total tertiary graduates ¹⁷	:	:	:	:	46.8	:	:	:
Spending on human resources ¹⁸	3.8	4.0	:	:	5.1	:	:	:
R&D expenditure ¹⁹	:	:	:	:	1.9	1.9	:	:
Expenditure on IT ²⁰	4.9	4.4	:	:	3.1	2.9	2.9	2.9

¹ Growth rate in percentage.

² Annual average rate of change in harmonised index of consumer prices in percentage.

³ Growth rate of real GDP per occupied person in percentage.

⁴ Growth rate of compensation per employee.

⁵ As a percentage of GDP.

⁶ Number of unemployed as a percentage of the labour force.

⁷ Employed persons aged 15-64 as a share of the total population of the same age group.

⁸ Employed women aged 15-64 as a share of the total female population of the same age group.

⁹ Employed persons aged 55-64 as a share of the total population of the same age group.

¹⁰ Long-term unemployed (over 12 months) as a percentage of the total active population aged 15-64.

¹¹ Income tax plus employer/employee contributions as a percentage of labour costs of a single earner at 67% of the Average Production Worker-wage, no children.

¹² Effective tax rate on labour income taking into account the combined effect of increased taxes and benefits withdrawal as an individual moves from unemployment back to work earning 67% of the Average Production Worker-wage, measured at the first month of unemployment (after any 'waiting period' if applicable).

¹³ GDP per hour worked in PPS, EU-15=100.

¹⁴ Percentage, average value of imports and exports of goods and services divided by GDP, multiplied by 100. For DE, ES, FR, IT, PL and the UK the value for EU-25 is the total for the large Member States, for all the other states the value for EU-25 is the total for the small Member States.

¹⁵ Percentage implemented in November 2004.

¹⁶ Gross fixed capital formation by the private sector as a percentage of GDP.

¹⁷ Total tertiary graduates (ISCED 5-6) per 1000 of population aged 20-29.

¹⁸ Public expenditure on education as a percentage of GDP.

¹⁹ GERD Gross domestic expenditure on R&D as a percentage of GDP.

²⁰ Expenditure on information technology as a percentage of GDP.

Source: Commission services (incl. Eurostat, structural indicators)

The data for 'general economic background' and 'public finance' are taken from the Commission's Autumn 2004 Economic Forecasts.

15. HUNGARY

Introduction

After slowing down in 2003, Hungary's real GDP growth became stronger again in 2004 (3.9 per cent). This was accompanied by a shift in growth components, towards strong export and investment, and less consumption based growth. The high real wage growth of the last three years also decelerated considerably. One of the major concerns regarding Hungarian economic policy is the high general government deficit, which reached 5.5³ per cent of GDP in 2004. While some consolidation was achieved in 2004, this was almost one percentage point less than originally envisaged by the authorities. Related to the fiscal performance is the high current account deficit of about 9 per cent of GDP in 2004. Against the background of the low employment and participation rates, a number of measures were carried out in order to promote employment and increase activity. Hungary was furthermore particularly successful in bringing down the previously high real wage growth to a moderate level below productivity growth. The level of labour productivity per person employed (at 63.4 per cent of the EU average) is relatively low but on average, for the period 1999 - 2003, the evolution has been quite impressive with a real annual growth rate which has been almost two percentage point higher than in the EU. Movement towards the knowledge based economy is slow and inefficiencies in the education system still exist. Finally, effective competition in the network industries should be further encouraged. These are factors which should be tackled in order to improve the growth prospects and competitiveness of the Hungarian economy in the medium term. A detailed assessment of recent developments in addressing Hungary's key policy challenges is presented in the following sections.

1. Public finances

Ensure a further reduction of the general government deficit on a sustainable basis

Under this challenge, Hungary was requested to:

1. reduce the general government deficit in a credible and sustainable way within a multi-annual framework in line with the decisions to be taken by the Council in the context of the forthcoming budgetary surveillance exercise.

Short-and long-term fiscal trends continue to be a cause for concern

Based on a general government deficit well above 3 per cent of GDP in 2003, on 5 July 2004, the Council decided that Hungary was in excessive deficit and recommended that this was to be corrected by 2008 at the latest. Specifically, Hungary was required to stand ready to introduce additional measures, with a view to achieving the general government deficit target of 4.6 per cent of GDP for 2004; and to take effective action by 5 November 2004 regarding the measures envisaged to achieve the 2005 deficit target of 4.1 per cent of GDP. In addition, the Council invited the Hungarian authorities to seize every opportunity to accelerate the fiscal adjustment, and to undertake the envisaged reforms of the public administration, health and education systems in order to ensure the foreseen reduction of the expenditure ratio and to improve the long-term sustainability of the public finances. Moreover, the Council emphasized that planned tax cuts should be adequately financed and that their implementation should be conditional upon the achievement of the deficit targets.

³ This figure (and all the others in the text) does not yet take into account the recent decision of the Hungarian authorities to make use of the possibility granted by Eurostat to temporarily (until the March 2007 fiscal notification) subtract the burden of the pension reform from the general government deficit figures. The correction for is 0.7, 0.8, 0.9 percentage point in 2003, 2004 and 2005 respectively, and 1.0 percentage point in the following years.

The Hungarian authorities decided to take a number of corrective measures in the course of 2004. However, by mid-September it became clear that this would not be sufficient, and the Hungarian authorities revised upwards the official general government target for 2004 from 4.6 per cent of GDP to 5.3 per cent of GDP. The slippage was mainly attributable to the upward revision of the 2003 deficit (by 0.3 percentage points of GDP), expenditure slippages and too optimistic revenue forecasts (mainly VAT).

The budget for 2005 contains a higher deficit target of 4.7 per cent of GDP compared to the 4.1 per cent of GDP target contained in the May 2004 convergence programme. However, largely reflecting carry-over effects and doubts on the implementation of planned reforms, even the upwards modified 2005 deficit target appeared to be subject to risk according to the Commission services Autumn 2004 forecasts which projected 5.2 per cent of GDP. While the measures of the 2005 budget include some reforms in the public administration, health and education sector, these seem not sufficient to achieve the path for deficit reduction specified in the May convergence programme and endorsed by the Council.

2. Labour market

Increase employment rates and address the structural problems in the labour market

Under this challenge, Hungary was requested to:

2. strengthen labour supply by removing obstacles to regional mobility through appropriate measures in the housing and transportation policy, and by encouraging disadvantaged groups (ethnic minorities, disabled and homeless people) to (re-)enter the labour market; and
3. ensure that the tax and benefit systems support employment and provide incentives to enter or remain in the labour market (make work pay - principle) - the high tax burden of labour force should be further reduced.

Some measures but with an uncertain impact

Hungary has one of the lowest unemployment rates among the new Member States (5.8 per cent in 2004). However, this is accompanied by a low employment rate (57 per cent in 2003). Low regional mobility is one of the reasons behind this phenomenon, with transportation and housing policy as the main obstacles. Commuting of the workforce is restricted by the deficiencies of the transport infrastructure and by high transportation costs on both intra and inter-regional level. The development of the motorway network, which is a key priority of the Hungarian authorities in the medium term, should improve the accessibility of the Eastern regions of the country and thus contribute towards job creation in these areas. However, sufficient emphasis should also be put on the construction, upgrading and capacity enhancement of smaller roads in regions with high unemployment in order to facilitate intra-community mobility. The high share of home ownership in the country – fostered by a generous housing loan scheme for several years –, a strongly underdeveloped market for rental housing, high duties on purchasing and selling flats, and significant regional differences in real estate prices limit the opportunities of domestic migration. While the housing loan scheme has been substantially tightened since mid-2003 – partly with effect in 2004, the new government programme for 2005 plans again to broaden somewhat the eligibility for new purchases, now mainly targeting young families with children. However, this step to more home ownership, though, does not seem to be counterbalanced by the efforts envisaged to reduce the shortage of low-rent flats. In general, there seems to be a serious lack of co-ordination among the public institutions concerned with mobility-improving measures. As a consequence, it is questionable whether the new measures would sufficiently take into account the characteristics of the targeted groups of clients, and whether these will be sufficient to increase significantly the mobility of the workforce.

Several measures to encourage disadvantaged groups

The authorities have adopted several measures in order to integrate disadvantaged persons into the labour market. A medium-term action plan was initiated in 2004, aimed at the promotion of education and training of the Roma minority in order to reduce long-term unemployment and to promote their labour market integration. In order to stimulate the employment of persons with altered working capabilities, the amount of the rehabilitation contribution imposed on employers was tripled. Generally, against the background of the high number of disability beneficiaries, it is a positive development that emphasis is increasingly put on rehabilitation. However, the revision of the disability benefits is also necessary to ensure that these efforts are successful. Another positive development is a programme starting in December 2004, aiming the employment of homeless people in Budapest region in the winter months. However, despite these efforts, in order to further improve the assistance to the disadvantaged groups, the formulation of clear priorities and basic principles concerning the development of employment policy measures would be beneficial, taking into account characteristics of the targeted groups of clients in the planning process on the localisation, the content and the time schedule of the programmes.

Encouraging measures to make work pay

The Hungarian social system is characterised by the wide availability of different kinds of transfers (early retirement, disability, generous maternity leave schemes etc). These transfers constitute – beside their significant negative fiscal impact – an important impediment to an active engagement in the labour market. A constant tightening of this generous scheme has been carried out in recent years: the statutory retirement age has been steadily increased, old-age pensions have been fully excluded from taxable income, and the statutory minimum wage has been gradually increased (and exempted from income tax) in order to be perceptively higher than the social benefits. However, there is still room for tightening eligibility criteria and their application, and for further measures encouraging people with remaining capability to re-enter the labour market. Although the revision of the social benefit system has started, no significant concrete measures were taken in 2004. Another problem is the high tax wedge on labour in an international comparison, restricting job creation and contributing to the wide existence of undeclared work. In this respect, the recent changes in the tax and social security system with effect in 2005 seem to contribute to a higher motivation to enter the labour market; whereas they have been implemented at a moment of insufficient fiscal consolidation, they were largely compensated by other changes in the tax system. These are notably: (1) low income earners benefit from the elimination of the medium bracket of the personal income tax scheme; (2) there was a 50 per cent reduction in social security contributions for those hiring job-starters, mothers returning from maternity leave and long-term unemployed over the age of 50; and (3) employers recruiting persons receiving child care allowance or child raising support as part-time employees or long-term unemployed persons over 50 are fully exempted from the flat-rate health contribution.

3. Wage policy

Enhance cost-competitiveness by pursuing policies that induce wage moderation

Under this challenge, Hungary was requested to:

4. encourage a reform of wage setting which allows wages to better reflect productivity. Promote multi-annual wage agreements with the social partners in order to keep real wage development in line with productivity growth.

Significant slowdown of real wage growth

After three years of high real wage growth exceeding productivity growth owing to a doubling of minimum wages and a 50 per cent increase in public wages, real wage growth came down to more moderate levels, below productivity growth, in 2004. Demonstration effects on wages are deriving, beside a central recommendation made by the tripartite National Reconciliation Council, from public-sector pay and minimum wage increases. Accordingly, the slowdown in wage growth in 2004 was induced by a moderate growth in the national minimum wage in 2003-2004 and a significant public wage moderation. After three years of high public wage growth the government committed itself to a wage moderation in the public sector (coupled with an ongoing downsizing of public sector employment). This was carried out in order to bring wage growth in line with productivity growth, but has also to be seen against the background of fiscal constraints. Private sector wage developments also moderated significantly, no significant changes were made in order to enforce central-level social dialogue. The government has an influential role in setting wages in the public sector, fixing mandatory minimum wages and issuing wage guidelines, for the private sector bargaining takes rather place on an enterprise or individual-level. On a longer run the role of industry level collective wage agreements might grow in the private sector due to the newly established Sectoral Dialogue Committees.

4. Productivity and business dynamism

Improve conditions for increasing productivity

Under this challenge, Hungary was requested to:

5. promote the stronger involvement of the private sector in R&D and innovation, strengthen the link between business and research institutions, ensure sufficient resources to improve the quality of research and support the transfer of knowledge through FDI (GL 13);
6. improve the efficiency of the education system, increase its flexibility in order to better adapt to the skill needs of the market and ensure adequate resources for vocational training and education (GL 13); and
7. ensure stability of legislation and government policies to create a business environment more supportive to entrepreneurship (GL 11).

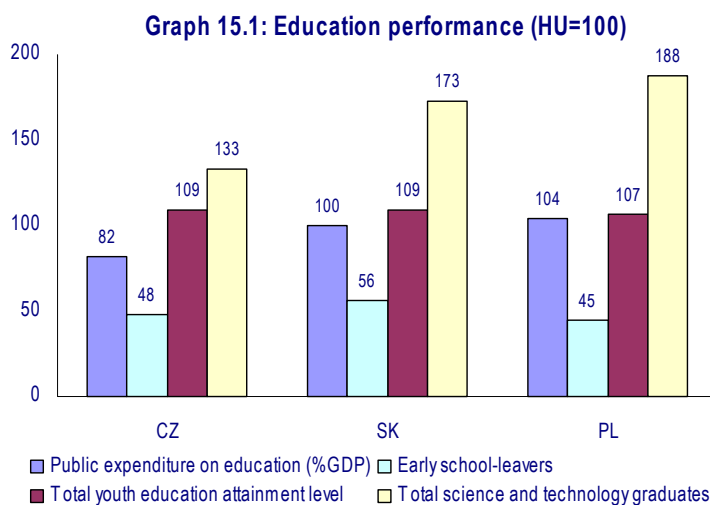
Movement towards the knowledge based economy is slow.

Since 1999, total R&D expenditures have increased at a higher rate in Hungary than in most of the other EU countries. However the level of R&D expenditures (0.97 per cent of GDP in 2003) remains low and the number of researchers and scientific publications is well behind the EU average, although it has recently started to improve significantly. In addition, the percentage of R&D expenditures financed by industry is amongst the lowest of the EU. It has even further declined during the recent years despite several fiscal incentives and initiatives to strengthen the link between business and research institutions. The number of Hungarian patent applications to the European Patent Office has declined over recent years. Though, compared to the other new Member States, the number of patent applications is higher. Finally, in 2003, a decrease could be observed in the amount of total inward foreign investment, which could diminish the transfer of technology towards Hungary. Nevertheless, the level and share of reinvested earnings have increased showing some confidence in the strengths of the Hungarian economy on the investors' part.

The education system is improving but is not efficient enough.

Even though the level of public expenditure on education is higher in Hungary than in other new Member States, its educational performance is often worse, pointing to the need to

improve the efficiency of the educational system. In this area, some measures have been taken to develop vocational training and the new act on higher education also encourages positive developments in the educational field. As a result, educational attainment of the population has already started to improve gradually. For instance, the percentage of Hungarians who have attained upper secondary education has increased from 50 per cent in 1998 to more than 57 per cent in 2002. The tertiary educational attainment level has started to rise as well, but at a slow pace and it is still amongst the lowest of the EU. The level of science and technology graduates is now the lowest amongst EU Member States.



Some measures have been taken to create a business environment more supportive to entrepreneurship.

Support is given to SMEs through grants for investment projects, improved access to finance and tax policy measures. Modernisation and technological development in SMEs are the two areas which have recently received most of the financial support. Furthermore, schemes allowing easier access to credit for SMEs have been extended. The corporate tax rate has decreased from 18 per cent to 16 per cent in 2004 which by EU standards places Hungary amongst the countries with the lowest tax rate on corporate income. Finally, the simplified entrepreneurial tax available for small enterprises has been a positive development in the reduction of administrative burdens on Hungarian SMEs. However, business investment as a percentage of GDP remains low in Hungary compared to other new Member States. According to the World Bank (2004), Hungary is also not ranked in the top quartile of 145 countries on the ease of doing business whereas its closest neighbours are.

5. Network industries

Develop effective competition in network industries

Under this challenge, Hungary was requested to:

8. proceed with the liberalisation of the network industries, increase effectiveness of competition and the independence of the network regulators (GL 9).

Effective competition in network industries should be further encouraged.

In the telecommunication sector, a new act which aims at increasing competition has been implemented from January 2004. Still, the incumbent dominates almost all segments of the market. The result of this low level of effective competition is that Hungarian telecommunication services remain relatively expensive compared to other EU countries. For instance, prices of national calls are the highest amongst EU-25 Member States. These are serious breaks to a large diffusion of new communication technologies to the Hungarian consumers. As a result, the level of broadband subscribers is amongst the lowest in the EU.

In the electricity market, all non households users became eligible from July 2004. In the gas sector, liberalization began on 1 January 2004 for big consumers, but from July 2004 all non

households users became eligible. Nevertheless, in electricity, more effective separation of transmission from the other activities is required and the conditions governing the entry of potential competitors should be made more favourable. Long term purchasing agreements and the lack of interconnection capacities are two other issues where further progress is needed in order to increase effective competition. In the gas sector, better access to pipelines and storage facilities and improved interconnection capacities are necessary to facilitate new entries. Finally, according to the International Energy Agency and the OECD (2004), the independence of the network regulator in both sectors should be further guaranteed as the government has retained some influence and could interfere in the price settings agreements.

Table 15.1: Economic indicators for Hungary

	Hungary				EU-25			
	2001	2002	2003	2004	2001	2002	2003	2004
General economic background								
Real GDP growth ¹	3.8	3.5	3.0	3.9	1.8	1.1	1.0	2.5
Inflation ²	9.1	5.2	4.7	6.9	2.5	2.1	1.9	2.2
Labour productivity growth ³	3.2	2.9	2.2	3.4	0.8	0.9	0.9	2.1
Employment growth ¹	0.6	0.6	0.9	0.5	1.0	0.3	0.3	0.4
Nominal wage growth ⁴	15.7	12.1	12.8	8.8	4.0	3.2	3.1	3.0
Current account ⁵	:	-7.1	-9.0	-8.7	:	:	:	:
Unemployment ⁶	5.6	5.6	5.8	5.8	8.5	8.9	9.1	9.1
Public finance								
General government balance ⁵	-4.4	-9.2	-6.2	-5.5	-1.2	-2.3	-2.8	-2.8
Primary balance ⁵	0.4	-5.1	-2.1	-1.1	2.4	1.0	0.3	0.2
Cyclically-adjusted balance ⁵	:	:	:	:	:	:	:	:
Gross government debt ⁵	53.5	57.2	59.1	59.7	62.1	61.6	63.2	63.5
Employment								
Employment rate ⁷	56.2	56.2	57	:	62.8	62.9	63.0	:
Female employment rate ⁸	49.8	49.8	50.9	:	54.3	54.7	55.1	:
Employment rate for older workers ⁹	23.5	25.6	28.9	:	37.4	38.8	40.2	:
Long-term unemployment ¹⁰	2.5	2.4	2.4	:	3.8	3.9	4.0	:
Tax rate on low wage earners ¹¹	45.8	46	41	:	37.2	37.1	37.4	:
Unemployment trap indicator ¹²	74.9	70	64.2	:	78.8	78.5	78.3	:
Product market reforms								
Hourly labour productivity ¹³	:	:	:	:	:	:	:	:
Total trade to GDP ratio ¹⁴	75.1	66.5	65.2	:	:	58.8	57.2	:
Internal Market Directives ¹⁵	:	:	:	98.1	:	:	:	96.3
Business investment ¹⁶	19.8	:	:	:	17.9	17.2	16.8	:
Knowledge-based economy								
Total tertiary graduates ¹⁷	36.2	38.9	:	:	46.8	:	:	:
Spending on human resources ¹⁸	5.2	5.4	:	:	5.1	:	:	:
R&D expenditure ¹⁹	1.0	1.0	1.0	:	1.9	1.9	:	:
Expenditure on IT ²⁰	3.0	2.6	2.8	2.8	3.1	2.9	2.9	2.9

¹ Growth rate in percentage.

² Annual average rate of change in harmonised index of consumer prices in percentage.

³ Growth rate of real GDP per occupied person in percentage.

⁴ Growth rate of compensation per employee.

⁵ As a percentage of GDP.

⁶ Number of unemployed as a percentage of the labour force.

⁷ Employed persons aged 15-64 as a share of the total population of the same age group.

⁸ Employed women aged 15-64 as a share of the total female population of the same age group.

⁹ Employed persons aged 55-64 as a share of the total population of the same age group.

¹⁰ Long-term unemployed (over 12 months) as a percentage of the total active population aged 15-64.

¹¹ Income tax plus employer/employee contributions as a percentage of labour costs of a single earner at 67% of the Average Production Worker-wage, no children.

¹² Effective tax rate on labour income taking into account the combined effect of increased taxes and benefits withdrawal as an individual moves from unemployment back to work earning 67% of the Average Production Worker-wage, measured at the first month of unemployment (after any 'waiting period' if applicable).

¹³ GDP per hour worked in PPS, EU-15=100.

¹⁴ Percentage, average value of imports and exports of goods and services divided by GDP, multiplied by 100. For DE, ES, FR, IT, PL and the UK the value for EU-25 is the total for the large Member States, for all the other states the value for EU-25 is the total for the small Member States.

¹⁵ Percentage implemented in November 2004.

¹⁶ Gross fixed capital formation by the private sector as a percentage of GDP.

¹⁷ Total tertiary graduates (ISCED 5-6) per 1000 of population aged 20-29.

¹⁸ Public expenditure on education as a percentage of GDP.

¹⁹ GERD Gross domestic expenditure on R&D as a percentage of GDP.

²⁰ Expenditure on information technology as a percentage of GDP.

Source: Commission services (incl. Eurostat, structural indicators)

The data for 'general economic background' and 'public finance' are taken from the Commission's Autumn 2004 Economic Forecasts.

16. MALTA

Introduction

The Maltese economy is small and relies heavily on international business to sustain investment and economic growth. Tourism and the manufacturing sector make up a large proportion of GDP. The economy is also characterised by a high number of micro enterprises with 95 per cent of all companies having less than 10 workers. Under a more favourable international economic environment Malta has continued with privatisation, industrial restructuring (the shipyard restructuring was accomplished in 2003) and liberalisation efforts and has made progress in these areas. Real GDP grew by 1 per cent in 2004, slightly recovering from the poor growth rates of the previous two years. Growth in 2004, fuelled by both gross fixed capital formation and a substantial turnaround in external demand, stood below the potential growth rate, but is projected to gradually increase in 2005 and 2006. Higher unemployment caused by industrial restructuring and households higher tax burden led a fall in private consumption, while public expenditure remained sluggish due to fiscal stringency. The most important challenges faced by Malta continue to be the consolidation of public finances, the increase of employment rates and the enhancement of competitiveness. The 2004 budget laid the foundations of strengthened fiscal discipline in Malta, envisaging an increase in public revenues mainly from indirect taxation and other fiscal streamlining measures, on the revenue side, coupled with public expenditure tightening. The government has also pursued efforts to improve the efficiency of the public sector which could help reduce the government deficit. Nevertheless, other necessary improvements with a direct impact on fiscal consolidation, such as the reform of the healthcare and pension systems, remain still to be tackled. Malta has also made progress in promoting ICT and in general improving the business environment. A detailed assessment of recent developments in addressing Malta's key policy challenges is presented in the following sections.

1. Public finances

Ensure a reduction of the general government deficit on a sustainable basis and the long-term sustainability of public finances

Under this challenge, Malta was requested to:

1. reduce the government deficit in a credible and sustainable way within a multi-annual framework in line with the decisions to be taken by the Council in the context of the forthcoming budgetary surveillance exercise (GL 1).

Fiscal consolidation is on the way...

On 5 July 2004, the Council decided that Malta was in excessive deficit and recommended that this be corrected by 2006 at the latest. Specifically, Malta was required to take action in a medium-term framework in order to bring the deficit below 3 per cent of GDP in 2006, implementing with vigour the measures envisaged in the May 2004 convergence programme, in particular those of a structural nature aimed at rationalising and reducing expenditures. The Maltese authorities were also required to ensure that the rise in the debt ratio, which exceeds the 60 per cent of GDP reference value, is brought to a halt in 2005 and reversed thereafter as specified in the 2004 convergence programme.

The general government deficit is expected to have narrowed from 9.7 per cent of GDP (9.6 per cent according to the Budget presented late November) in 2003⁴ to 5.1 per cent of GDP

⁴

Including a one-off measure in the public shipyards amounting to 3.2 per cent of GDP.

(5.2 per cent according to the Budget) in 2004, thus achieving the target for 2004 set by the government in the May 2004 convergence programme (5.2 per cent). Total current revenues grew higher than projected in the budget while current expenditure grew much less than foreseen in the budget. Capital expenditure remained high due to the continuation of a major hospital construction project and to outlays related to the completion of works under the Italian Financial Protocol.⁵ The attainment of the fiscal target for 2004 also hinges on the estimate for a nominal GDP growth for 2004 of 4.4 per cent (according to the Budget the target would still be reached with a nominal growth of 3.0 per cent). On a no-policy change basis, the Commission services Autumn 2004 forecast projected that the general government deficit for 2005 and 2006 would remain above the targets set in the May 2004 Maltese convergence programme. However, the 2005 budget added new measures to increase fiscal stringency, making the fiscal targets attainable.

2. Labour market

Increase employment rates, especially among women

Under this challenge, Malta was requested to:

2. streamline the tax-benefit system interaction to strengthen the incentives to work, within the context of the Government's fiscal consolidation process (GL 4);
3. improve the quality of secondary education and vocational training (GL 8); and
4. strengthen retraining of labour to make it more adaptable in the case of labour-shedding and facilitate the return to work of middle-age women (GL 8).

The streamlining of the tax-benefit system interaction remains to be accomplished...

So far, the government has not carried out reforms to ensure that the tax and benefit interaction have a favourable impact on those furthest from the labour market.

The short-term impact of recent measures in education and vocational training cannot yet be assessed...

Youth educational attainment level in Malta is the lowest in the EU and lags far behind the EU average. However, the situation saw some improvement between 2000 and 2003 as the proportion of 20-24 year olds that have completed at least an upper secondary education increased from 40 to 46 per cent. Opportunities for lifelong learning have also proliferated in the public and private sectors alike. With regard to entrepreneurial training, the last few years have seen a number of initiatives by different stakeholders, in a somewhat fragmented manner. The Business Promotion Act provides for grants to firms that train their workers, and these provisions will be reviewed and improved upon. Training in literacy and basic skills has increased as well. The outcomes of these measures are expected to become increasingly visible in the years to come.

...but gender equality appears closer ...

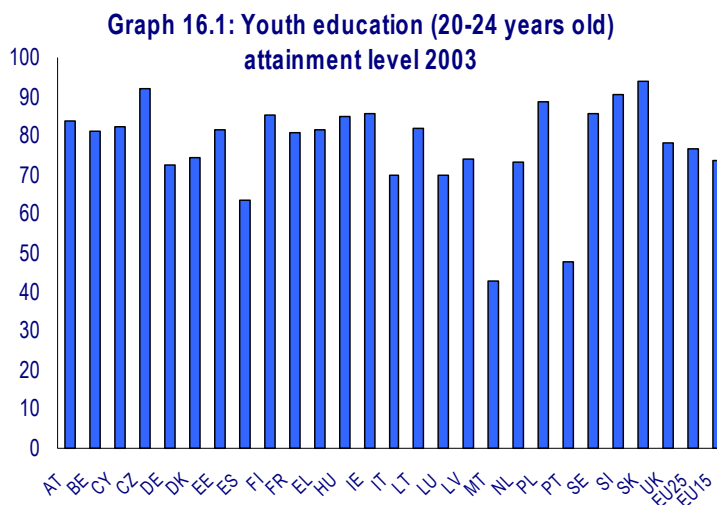
The government is currently designing a package of incentives to increase female labour market participation. It will also promulgate standards to regulate the provision of childcare, provide incentives to both providers and users of childcare, and will make best use of the European Social Fund to further childcare provision. A key actor in the promotion of gender equality in the labour market will be the National Commission on the Promotion of Equality between Women and Men. Its strategic priorities for the years 2004 – 2006 are to raise awareness of equality and of the Commission itself; develop guidelines and procedures for

⁵

Co-operation agreement between Malta and Italy which expires in 2005.

handling complaints of discrimination; network with other entities to strengthen women's labour market position; study the issue of gender targets; and monitor laws and collective agreements from a gender perspective.

These initiatives constitute a positive step but at this stage it is too early to make a proper appraisal of their effects. Measures to facilitate the return to work of middle age women remain to be implemented.



3. Productivity and business dynamism

Encourage effective competition taking into account the specific characteristics of the small domestic economy

Under this challenge, Malta was requested to:

5. pursue the efforts to increase competition in certain sectors such as network industries, food industries, and shipbuilding (GL 9).

Continued efforts to improve competition

The government has continued to pursue efforts to provide the right environment for competition to develop. In the first quarter of 2004, regulations establishing rules for the licensing of activities in the electricity sector and relating to electricity tariffs, among other things, came into force. Also in 2004, one of the routes of transport operated by a monopoly ferry service was liberalised and the government published a white paper on a new framework for the electronic communications market.

Legislation to restructure the ship repair and shipbuilding industry came into force on 7th November 2003. The shipbuilding and ship repair industry is currently a major beneficiary of state aid but the restructuring programme aims to phase out these subsidies by 2008 in line with the transition period agreed during the accession negotiations. In the food industry, the dismantling of levies on agriculture and agro-food products was finalised by Malta's accession to the EU on 1st May 2004.

The government has continued with its privatisation programme as part of efforts to increase competition and efficiency. The privatisation of the National Lottery Licence was accomplished in February 2004. The privatisation unit completed evaluation of the expressions of interest from various companies for the privatisation of the Sea Malta, the commercial national shipping line. The government has announced its intention to carry out the privatisation process for a number of its holdings, notably Bank of Valletta plc, a leading financial services provider, and Maltacom plc, the main telecommunications provider.

Table 16.1: Economic indicators for Malta

	Malta				EU-25			
	2001	2002	2003	2004	2001	2002	2003	2004
General economic background								
Real GDP growth ¹	-2.2	1.8	0.2	1.0	1.8	1.1	1.0	2.5
Inflation ²	2.5	2.6	1.9	3.7	2.5	2.1	1.9	2.2
Labour productivity growth ³	-4.1	2.5	1.2	0.4	0.8	0.9	0.9	2.1
Employment growth ¹	2.1	-0.7	-1.0	0.6	1.0	0.3	0.3	0.4
Nominal wage growth ⁴	5.9	1.5	1.5	0.6	4.0	3.2	3.1	3.0
Current account ⁵	:	:	:	-4.0	:	:	:	:
Unemployment ⁶	6.7	7.5	8.2	8.6	8.5	8.9	9.1	9.1
Public finance								
General government balance ⁵	-6.4	-5.8	-9.6	-5.1	-1.2	-2.3	-2.8	-2.8
Primary balance ⁵	-2.8	-1.9	-5.9	-1.3	2.4	1.0	0.3	0.2
Cyclically-adjusted balance ⁵	:	:	:	:	:	:	:	:
Gross government debt ⁵	62.0	62.3	70.4	72.4	62.1	61.6	63.2	63.5
Employment								
Employment rate ⁷	54.3	54.4	54.2	:	62.8	62.9	63.0	:
Female employment rate ⁸	32.1	33.9	33.6	:	54.3	54.7	55.1	:
Employment rate for older workers ⁹	29.4	30.1	32.5	:	37.4	38.8	40.2	:
Long-term unemployment ¹⁰	3.2	3.3	3.5	:	3.8	3.9	4.0	:
Tax rate on low wage earners ¹¹	17.4	18.1	15.8	:	37.2	37.1	37.4	:
Unemployment trap indicator ¹²	64.4	64.4	64.2	:	78.8	78.5	78.3	:
Product market reforms								
Hourly labour productivity ¹³	:	:	:	:	:	:	:	:
Total trade to GDP ratio ¹⁴	83.4	82.5	79.5	:	:	58.8	57.2	:
Internal Market Directives ¹⁵	:	:	:	94.7	:	:	:	96.3
Business investment ¹⁶	17.0	14.3	16.1	:	17.9	17.2	16.8	:
Knowledge-based economy								
Total tertiary graduates ¹⁷	32.7	:	:	:	46.8	:	:	:
Spending on human resources ¹⁸	4.5	4.5	:	:	5.1	:	:	:
R&D expenditure ¹⁹	:	:	:	:	1.9	1.9	:	:
Expenditure on IT ²⁰	:	:	:	:	3.1	2.9	2.9	2.9

¹ Growth rate in percentage.

² Annual average rate of change in harmonised index of consumer prices in percentage.

³ Growth rate of real GDP per occupied person in percentage.

⁴ Growth rate of compensation per employee.

⁵ As a percentage of GDP.

⁶ Number of unemployed as a percentage of the labour force.

⁷ Employed persons aged 15-64 as a share of the total population of the same age group.

⁸ Employed women aged 15-64 as a share of the total female population of the same age group.

⁹ Employed persons aged 55-64 as a share of the total population of the same age group.

¹⁰ Long-term unemployed (over 12 months) as a percentage of the total active population aged 15-64.

¹¹ Income tax plus employer/employee contributions as a percentage of labour costs of a single earner at 67% of the Average Production Worker-wage, no children.

¹² Effective tax rate on labour income taking into account the combined effect of increased taxes and benefits withdrawal as an individual moves from unemployment back to work earning 67% of the Average Production Worker-wage, measured at the first month of unemployment (after any 'waiting period' if applicable).

¹³ GDP per hour worked in PPS, EU-15=100.

¹⁴ Percentage, average value of imports and exports of goods and services divided by GDP, multiplied by 100. For DE, ES, FR, IT, PL and the UK the value for EU-25 is the total for the large Member States, for all the other states the value for EU-25 is the total for the small Member States.

¹⁵ Percentage implemented in November 2004.

¹⁶ Gross fixed capital formation by the private sector as a percentage of GDP.

¹⁷ Total tertiary graduates (ISCED 5-6) per 1000 of population aged 20-29.

¹⁸ Public expenditure on education as a percentage of GDP.

¹⁹ GERD Gross domestic expenditure on R&D as a percentage of GDP.

²⁰ Expenditure on information technology as a percentage of GDP.

Source: Commission services (incl. Eurostat, structural indicators)

The data for 'general economic background' and 'public finance' are taken from the Commission's Autumn 2004 Economic Forecasts.

17. NETHERLANDS

Introduction

In 2004, budgetary policy was determined by the sharp deterioration of the fiscal position in 2002 and 2003, which mainly resulted from the protracted economic slump, and the government's determined efforts to reduce the deficit to below the threshold of 3 per cent of GDP. The subdued labour productivity growth in 2002 and 2003 stems from the combination of cyclical factors and from remaining product market imperfections in some sectors and relatively low innovative capacity. Despite the efforts, structural reforms have not yet resulted in higher trend productivity and productivity growth. A detailed assessment of recent developments in addressing key policy challenges in the Netherlands is presented in the following sections.

1. Public Finances

Pursue budgetary adjustment in the coming years in the face of weaker potential growth, and the budgetary costs of ageing	Assessment
Under this challenge, the Netherlands was requested to:	
1. stand ready to take the necessary measures in response to the existence of 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 (GL 1 and 14).	In progress
Bearing in mind the three-year period available for implementation, the degree of implementation since 2003 is indicated as: "Complete" for (practically) complete; "In progress" where progress is well advanced; "Limited" where the recommendation is only partially addressed and "Insufficient" where no substantial measures going in the right direction have been taken.	

Deficit exceeded 3 per cent of GDP limit in 2003, leading to the launch of the excessive deficit procedure.

Based on a general government deficit of 3.2 per cent of GDP in 2003, the Council decided on 2 June 2004 that the Netherlands were in excessive deficit and recommended that this be corrected by 2005 at the latest. To this end, the Netherlands were required to take effective action by 2 October 2004 regarding corrective measures in 2005, mainly of a structural nature. In addition, the Council urged the Dutch authorities to ensure that budgetary consolidation towards a position close to balance or in surplus is sustained.

A substantial consolidation effort is estimated to bring the deficit below 3 per cent of GDP from 2004.

The 1.3 per cent of GDP increase in the general government deficit to 3.2 per cent of GDP in 2003 occurred despite substantial fiscal tightening. It has shown, among other things, the sensitivity of Dutch public finances to the deep and protracted economic slowdown. In order to stem the worsening of the public accounts, the authorities promptly implemented a supplementary package of savings equivalent to 0.6 per cent of GDP 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 per cent of GDP in 2004.

The 2005 budget contains consolidation measures equivalent to around half a percentage point of GDP. The deficit-reducing measures in the 2005 budget comprise cuts in health expenditures, increases in income tax rates, reduced access to unemployment benefits, higher

disability premiums, and the phasing out of subsidies on low-paid labour. For a large part, the savings in 2005 reflect the structural impact of measures that were part of the April 2004 adjustment package. The main additional savings in the 2005 budget are an increase in the rate for the first two income tax brackets and further cuts in net spending of ministries. In 2006, an end to fiscal facilities for early retirement would also help improve the general government balance. In the wake of fiscal tightening and a recovery in revenues in line with the expected economic upturn, the deficit is expected to fall to 2.4 per cent of GDP in 2005 and, on a no policy change basis, to 2.1 per cent of GDP in 2006 according to the Commission Autumn 2004 forecast. According to the Commission forecast, the cyclically adjusted deficit would remain at around 1 per cent of GDP in 2005 and 2006, so further adjustments might be needed to achieve a fiscal position close to balance.

2. Labour market

Draw currently inactive people into the labour market	Assessment
Under this challenge, the Netherlands was requested to:	
2. push forward with reforms of benefit systems in order to make work pay (GL 4). Concentrate, in particular, on benefit eligibility and conditionality. Legislate and implement the planned reform of the disability scheme, thereby paying attention to both the inflow and to the activation of those who already receive benefits.	In progress

Profound reforms of the social security and pension systems ...

Against the background of the deterioration in public finances and the ensuing corrective budgetary measures, the government is pursuing a deep-rooted overhaul of the social security and pension systems. The rationale for these reforms is to boost labour participation and to secure the ensuing budgetary savings. Following up on action taken already in 2003 (discussed in the 2004 Implementation Report) and encompassing several measures taken in the Spring of 2004, the 2005 budget (as amended by Parliament) specifies a series of far-reaching measures.

Measures include a limitation of the maximum duration of unemployment benefits, to improve incentives to take up work. Some proposals have been put on hold awaiting advice by the Social Economic Council. This regards in particular the proposals to abolish the special unemployment benefit for persons with short work records and to limit lump-sum payments which employees may receive after lay-offs without unemployment benefits being reduced (which actually risks hindering matching in the labour market, thus offsetting budgetary gains).

Progress has been made in the integrated approach of job search and benefit determination. As a consequence, full financial and administrative responsibility for those in welfare benefits lies with the municipalities as of 2004. Moreover, the streamlining of various income-dependant subsidies should enhance efficiency in the implementation, with a larger role for the tax administration.

Subsidies on low-paid labour will be phased out by 2006. These subsidies implied a large deadweight loss, limiting the efficiency of the subsidies in enhancing employment. However, the increase in the two lowest income tax brackets in 2005 will partly reverse the reductions of marginal tax rates for low-to-medium incomes in recent years (which promoted employment growth), while progress in the removal of poverty traps has been slow.

A reform of the disability scheme will be implemented with effect from 2006. The restructuring implies stricter eligibility, aimed at reducing both the inflow and the stock of

current recipients and at an adjustment of the incentive structure. The period of illness before being eligible for a disability benefit will be lengthened to two years. During this two year period, the employer will have to pay sickness benefits. The reform will be reviewed after its implementation. A positive assessment would lead to an increase in the benefit level for those deemed fully and permanently disabled⁶, while the current (successful) differentiation in disability premium payments on the part of employers would be abolished. As regards child care, new rules of financing will apply as of 2005, with the aim to split costs among parents, employers, and the government. To the extent that the employer indeed pays, the impact for low-to-medium wage earners appears to be positive. A major drawback, however, is that disincentives remain to take up work when only one of the two spouses is employed.

As regards pensions, the government will end fiscal facilitation of pre-pension and early retirement schemes in 2006. While this should help to enhance fiscal sustainability, the long transition period granted for those who are 55 years or older at the start of the new system risks leading to early retirement of persons that are still eligible. Moreover, social partners might (partly) offset the intended impact through a faster accumulation of tax-exempt ordinary pension rights. Even though the introduction of an element of choice adds flexibility compared to existing pre-pension arrangements, this could leave in place a high implicit tax on working until the statutory pension age, thereby not fully addressing the problem of low labour participation among over 55s.

Finally, the government launched an initiative for a fiscal savings scheme ('levenslooplegeling') to facilitate career breaks. Its modalities do not imply a sizeable improvement over existing fiscal arrangements. It risks being used primarily as an alternative route to early retirement for certain older employees, while not appreciably alleviating the burden on people in the age group combining a career and raising children.

On balance, several measures are aimed at limiting eligibility for social security and disability benefits and promote labour participation. The new measures imply a substantial overhaul of social security and pension regulations. Due to this encompassing approach substantial progress in implementing the recommendations has been made in the last year or will be made in 2005 and 2006. However, in some areas, notably pension reform, doubts exist about the actual effectiveness in terms of influencing the actual behaviour of economic agents, and thus achieving their intended aim.

... mitigated in the wake of social agreement.

Dissatisfaction among social partners with key elements of the government plans in the areas of pensions and social security led to calls for modification of the government plans. On 5 November 2004, the government reached an agreement with social partners and modified the plans in certain respects. The Social Economic Council should come up with budget-neutral alternative proposals for the elements of the reform of the unemployment and disability schemes that have been put on hold awaiting its advice. In addition, an agreement was reached to moderate contractual wage increases, while collective labour agreements would remain binding. The budgetary costs of the adjustments are estimated to be limited, at less than 0.1 per cent of GDP in 2006.

⁶ In the social agreement reached on 5 November 2004 the definition of 'permanently disabled' has been mitigated to include persons with a 'small chance' of recovery.

3. Productivity and business dynamism

<p>Tackle the relative slow productivity growth, stemming, inter alia, from the low level of competition in some sectors, and insufficient business investment, particularly in R&D</p>	<p>Assessment</p>
<p>Under this challenge, the Netherlands was requested to:</p>	
<p>3. improve the regulatory framework as well as its implementation (GL 11), especially in sectors where competition has been found to be inadequate, such as construction and professional services; and</p>	<p>In progress</p>
<p>4. promote a more technology oriented education and strengthen science-industry links with the aim of increasing business investment in R&D (GL 13).</p>	<p>Limited</p>

Some measures were taken to improve the regulatory framework ...

The bill strengthening the Dutch Competition Authority (NMa) and broadening its competences came into force on 1 August 2004. In 2003, the NMA addressed competition problems in the construction industry, health care, the financial sector and the energy sector. In the last sector, markets have been fully liberalised since July 2004 and network unbundling should take effect by 1 January 2007 at the latest. Quantified targets for a reduction in the administrative burden will be set up for each ministry in 2005. A more intensive use of ICT should also help to reduce administrative costs. One example is the national electronic one-stop-shop for businesses that is currently under construction.

... and to strengthen the innovative capacity of the Dutch economy.

The Innovation Platform, created in 2003, has organised consultation groups and issued policy recommendations, but few concrete measures were taken as a follow-up.⁷ Nevertheless, measures, mainly targeted at universities, were taken to stimulate the industry-university links (university patent policy, start-ups, spin-offs, TechnoPartner Action Programme). The “Deltaplan bèta en techniek” aims at increasing the inflow of science and technology students by, for example, bringing school pupils in contact with science and technology. Finally, initiatives have been taken to boost the entrepreneurial orientation of students (Action Entrepreneurship in the Education System). Despite the undertaken reforms, the share of R&D financed by the industry is below the EU-15 average and shows a negative trend. Similarly, the number of students in science and technical course remains below the EU average.

⁷

Relaxation of regulations for migrant knowledge workers, innovation vouchers for SMEs, smart mix for the university funding, increased mobility of researchers.

Table 17.1: Economic indicators for the Netherlands

	Netherlands				EU-25			
	2001	2002	2003	2004	2001	2002	2003	2004
General economic background								
Real GDP growth ¹	1.4	0.6	-0.9	1.4	1.8	1.1	1.0	2.5
Inflation ²	5.1	3.9	2.2	1.2	2.5	2.1	1.9	2.2
Labour productivity growth ³	0.1	0.7	0.1	3.2	0.8	0.9	0.9	2.1
Employment growth ¹	1.3	-0.1	-1.0	-1.7	1.0	0.3	0.3	0.4
Nominal wage growth ⁴	5.5	6.2	3.9	2.4	4.0	3.2	3.1	3.0
Current account ⁵	3.8	2.8	2.7	3.7	:	:	:	:
Unemployment ⁶	2.5	2.7	3.8	4.6	8.5	8.9	9.1	9.1
Public finance								
General government balance ⁵	-0.1	-1.9	-3.2	-2.9	-1.2	-2.3	-2.8	-2.8
Primary balance ⁵	3.3	1.1	-0.3	0.0	2.4	1.0	0.3	0.2
Cyclically-adjusted balance ⁵	-1.3	-2.0	-1.8	-1.4	:	:	:	:
Gross government debt ⁵	52.9	52.6	54.1	55.7	62.1	61.6	63.2	63.5
Employment								
Employment rate ⁷	74.1	74.4	73.5	:	62.8	62.9	63.0	:
Female employment rate ⁸	65.2	66.2	65.8	:	54.3	54.7	55.1	:
Employment rate for older workers ⁹	39.6	42.3	44.8	:	37.4	38.8	40.2	:
Long-term unemployment ¹⁰	0.7	0.7	1	:	3.8	3.9	4.0	:
Tax rate on low wage earners ¹¹	36.8	37	37.6	:	37.2	37.1	37.4	:
Unemployment trap indicator ¹²	85.2	84.8	85.7	:	78.8	78.5	78.3	:
Product market reforms								
Hourly labour productivity ¹³	115.9	112.9	112.3	:	:	:	:	:
Total trade to GDP ratio ¹⁴	68.4	67.3	66.1	:	:	58.8	57.2	:
Internal Market Directives ¹⁵	98.7	98.7	97.4	98.0	:	:	:	96.3
Business investment ¹⁶	18.3	17.1	16.5	:	17.9	17.2	16.8	:
Knowledge-based economy								
Total tertiary graduates ¹⁷	39.2	42.0	:	:	46.8	:	:	:
Spending on human resources ¹⁸	5.0	5.1	:	:	5.1	:	:	:
R&D expenditure ¹⁹	1.9	:	:	:	1.9	1.9	:	:
Expenditure on IT ²⁰	3.9	3.6	3.5	3.5	3.1	2.9	2.9	2.9

¹ Growth rate in percentage.

² Annual average rate of change in harmonised index of consumer prices in percentage.

³ Growth rate of real GDP per occupied person in percentage.

⁴ Growth rate of compensation per employee.

⁵ As a percentage of GDP.

⁶ Number of unemployed as a percentage of the labour force.

⁷ Employed persons aged 15-64 as a share of the total population of the same age group.

⁸ Employed women aged 15-64 as a share of the total female population of the same age group.

⁹ Employed persons aged 55-64 as a share of the total population of the same age group.

¹⁰ Long-term unemployed (over 12 months) as a percentage of the total active population aged 15-64.

¹¹ Income tax plus employer/employee contributions as a percentage of labour costs of a single earner at 67% of the Average Production Worker-wage, no children.

¹² Effective tax rate on labour income taking into account the combined effect of increased taxes and benefits withdrawal as an individual moves from unemployment back to work earning 67% of the Average Production Worker-wage, measured at the first month of unemployment (after any 'waiting period' if applicable).

¹³ GDP per hour worked in PPS, EU-15=100.

¹⁴ Percentage, average value of imports and exports of goods and services divided by GDP, multiplied by 100. For DE, ES, FR, IT, PL and the UK the value for EU-25 is the total for the large Member States, for all the other states the value for EU-25 is the total for the small Member States.

¹⁵ Percentage implemented in November 2004.

¹⁶ Gross fixed capital formation by the private sector as a percentage of GDP.

¹⁷ Total tertiary graduates (ISCED 5-6) per 1000 of population aged 20-29.

¹⁸ Public expenditure on education as a percentage of GDP.

¹⁹ GERD Gross domestic expenditure on R&D as a percentage of GDP.

²⁰ Expenditure on information technology as a percentage of GDP.

Source: Commission services (incl. Eurostat, structural indicators)

The data for 'general economic background' and 'public finance' are taken from the Commission's Autumn 2004 Economic Forecasts.

18. AUSTRIA

Introduction

Benefiting from a booming world economy, in 2004 GDP growth in Austria gathered momentum after the slowdown of 2003. This brought about an improvement in the labour market, with a slight reduction in the number of unemployed. The general government deficit, however, remained practically unchanged at 1¼ per cent of GDP as both revenue and expenditure ratios fell. A tax reduction in 2005 is expected to lift the deficit to around 2 per cent of GDP in spite of economic activity expected to remain firmly upward bound. Following a fairly high pace of reforms in 2003 with the implementation of a substantial and welcome overhaul of the pensions system, 2004 brought further developments with the “pension harmonisation law” that will introduce a new system of individual pension accounts. The 2004 law achieves its goals to a large degree. However this also leads to individual pension accounts that are non-transparent to the insured and contains some concessions that temporarily undo a part of the exonerating budgetary effects of the 2003 law, while resulting in additional expenditure savings in the long run. Austria continues to rationalise and streamline its R&D and innovation support. Increased R&D spending and the recent educational reform should speed up the transition towards the knowledge-based economy. Moreover, the current reform of higher education might help increase the very low levels of graduates. The business environment is improving due to the measures taken to support entrepreneurship and SMEs, and to the reduction of the corporate tax rate from 34 per cent to 25 per cent. However, effective competition particularly in the liberal professions remains low. Efforts to increase competition in network industries suffered a setback, as the only foreign electricity retailer has left the market. A detailed assessment of recent developments in addressing Austria’s key policy challenges is presented in the following sections.

1. Long-term sustainability of public finances

Draw currently inactive people into the labour market	Assessment
Under this challenge, Austria was requested to:	
1. implement measures leading to structural expenditure savings, also at lower levels of government, so as to lower the high tax burden, while securing a cyclically-adjusted budgetary position close to balance (GL 1); and	Limited
2. reform the public pension system to ensure the sustainability of public finances (GL 16); in particular link more closely the level of pension benefits to life-long contributions; increase the low average effective retirement age and ensure in this context that incentives to work are enhanced (GL 4), with a view to raising the labour market participation of older workers	In progress
Bearing in mind the three-year period available for implementation, the degree of implementation since 2003 is indicated as: “Complete” for (practically) complete; “In progress” where progress is well advanced; “Limited” where the recommendation is only partially addressed and “Insufficient” where no substantial measures going in the right direction have been taken.	

2004 deficit almost double the planned size...

In 2004, the general government deficit edged up from 1.1 per cent of GDP in 2003 to 1.3 per cent of GDP, whereas the 2003 update of the stability programme had projected a deficit reduction to 0.7 per cent of GDP. According to the 2004 update of the stability programme,, all levels of government performed below the stability programme target, the federal level

fell short of its target by 0.3 per cent of GDP as did the state and local level. The social security accounts did not reach the projected surplus of 0.1 per cent of GDP, but remained in balance.

...due to overspending.

The 2003 update of the stability programme had projected a reduction in the expenditure share in GDP by 1.2 percentage points in 2004, while the 2004 update estimates that the ratio was reduced by only 0.6 percent of GDP. The general government revenue share in GDP fell in 2004 by only little more than expected in the 2003 stability programme. This implies that the first stage of the income tax reform, amounting to a tax relief worth 0.1 per cent of GDP in 2004 (including some measures of the 2005 tax reform brought forward to 2004), was accompanied by much less expenditure restraint than planned. Much of the expenditure slippage (in national accounts definition) resulted from the incremental investment premium (*Investitionszuwachsprämie*), which was taken up by companies to a much larger extent than expected by the government. Expenditure on unemployment benefits was also slightly higher than expected.

In 2005, the second stage of the income tax reform is taking effect, amounting to a tax relief worth 1 per cent of GDP. The tax reform is deliberately not contemporaneously counter-financed, thus the general government deficit widens to 2.0 per cent of GDP according to the Commission Autumn 2004 forecast. As a result, the Commission estimates the cyclically-adjusted balance to have widened by 0.2 pp to -1.0 per cent of GDP in 2004, rising further to -1.9 per cent in 2005 and, on a no-policy-change basis, falling slightly to -1.7 per cent of GDP in 2006. Hence, despite lowering the tax burden, Austrian budgetary policy failed to implement structural savings and is moving further away from a cyclically-adjusted position close to balance. For the period from 2005 to 2008, the different levels of government concluded a new fiscal revenue sharing act and a new national stability pact, which outline the adjustment path for each level of government to arrive at a balanced budget for general government by 2008, thereby postponing the consolidation promised in earlier stability programmes. Although the national stability pact provides some incentives to follow the planned path, its achievement is unlikely under a no-policy change scenario, and the 2004 update of the stability programme explains only partly the specific measures needed to achieve them.

Ambitious pension reform implemented in 2004...

As reviewed in the 2004 Implementation Report, Austria passed a substantial pension reform law in 2003, taking effect in 2004. In the long term, the actuarial fairness of the public pension system will be enhanced by extending the assessment period for the individual benefit entitlements and by gradually raising the statutory retirement age, expected to lead to higher labour market participation of the elderly.

...but partly undone in 2005.

With the aim of bringing all groups of private and public sector employees into a harmonised pension system, a further pension reform law was passed in 2004 (*Pensionsharmonisierung*). The significant contribution of the 2004 law to long-term financial sustainability is now being back-loaded to take effect only after 2030, while partly reducing the medium-term savings from the 2003 law. More specifically:

- Pension levels will be adjusted annually for consumer price inflation only, which is the main driver of future expenditure savings. An automatic adjustment for demographic change is not foreseen, but the government is obliged to report every three years on demographic change and to propose measures how to cope with its financial implications.

- The expenditure savings will take effect only from 2030 on, while the medium-term savings from the 2003 reform are partly undone. For entitlements, two so-called “parallel calculations” are carried out. The first accounts for a weighted average of the entitlements before and after the 2003 law, and the second accounts for the entitlements under the 2004 law. In total, the loss from the 2003 reform (the first calculation) is partly undone. Moreover, the method of calculating individual benefit levels is not transparent to the insured. It will thus not facilitate rational choices on working time, the timing of retirement or child care.
- The goal of harmonisation remains incomplete, in particular civil servants older than 50 years are not subject to the new regulation and the Länder will yet have to apply the rules to their civil servants. Furthermore, employees, farmers and self-employed continue to pay different contribution rates that do not fully reflect differences in entitlements (e.g. for periods of unemployment or child care).
- Although the statutory retirement age remains at 65 years, the draft law introduces a “corridor” for early retirement, beginning at 62 years of age and aiming at actuarially fair discount rates. Employees within this age corridor that are made redundant by their employer would be entitled to one further year of unemployment benefits before they must take up the “corridor” pension. As the statutory retirement age of 62 will apply to women as from 2027, they would be entitled to the corridor pension from 2028 on.

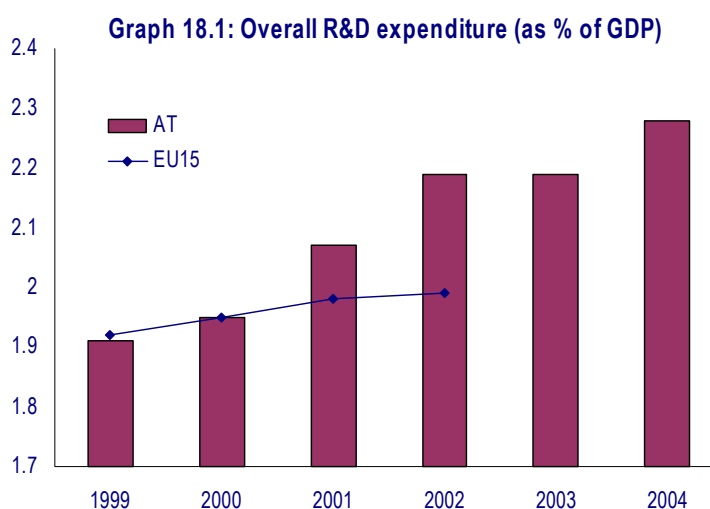
The law further contains an early retirement clause for workers having done heavy-duty manual labour, with the aim to restrict it to 5% of new retirees. While such workers may indeed have a lower life expectancy, the eligibility criteria are still to be elaborated by an ad-hoc working group.

2. Productivity and business dynamism

Continue to improve the weak technology base, and encourage business R&D and innovation	Assessment
Under this challenge, Austria was requested to:	
3. take measures to encourage business research and innovation, especially for SMEs, (GL 13).	In progress

Spending on R&D has been steadily increasing ...

The sustained effort of Austria to boost R&D and innovation is producing results. The 2003 European Innovation Scoreboard shows that Austria is closing the innovation gap vis-à-vis the EU average. The steadily increasing overall R&D expenditures reached 2.2 per cent of GDP in 2003 and are expected to rise to 2.3 per cent in 2004. As regards public spending, Austria has approved additional resources for R&D for the period 2004-



2006. The share of R&D expenditures financed by industry (42.6 per cent in 2004) is considerably lower than the EU average.

... and the institutional setup for R&D promotion is being restructured.

The government has continued to streamline and rationalise the complicated system of R&D and innovation support. First, the Austrian Research Promotion Company (*Forschungsförderungsgesellschaft*) was founded by merging four independent sectoral institutions. Second, the fund providing resources for scientific research (FWF) was reformed in order to modernise the organisational structure and increase transparency. Third, the independence of the Council for Research and Technological Development, which decides about the distribution of the funds for R&D, was increased. Finally, the National Foundation for RTD was created which will annually distribute grants amounting to around 125 million euro. The numerous programmes for support of R&D and innovation and technology transfer in companies and particularly SMEs (e.g. Protec 2002+, Kplus, RegPlus) continued operating. As regards other measures to boost R&D, as part of the ongoing tax reform, the adjustment of the taxation of groups in order to attract headquarters and R&D facilities to the country, will be implemented by 1 January 2005.

3. Competition

Strengthen the development of effective competition in some sectors	Assessment
Under this challenge, Austria was requested to:	
4. increase the resources of the competition authority and to take measures to enhance effective enforcement of regulators' decisions in telecommunications (GL 9).	Limited

Effective competition in some sectors increased ...

As elaborated in the 2004 BEPGs Implementation Report, measures to increase effective competition were implemented (partial liberalisation of the regulation on opening hours in the retail sector, decrease in start-up costs and easier access to several professions). The number of newly founded enterprises increased considerably by over 9 per cent in 2003. While the business environment had improved, part of this rise was the result of the above-mentioned investment premium subsidy, which also gave incentives for existing companies to undertake new investment in newly founded companies. Limited competition in some sectors remains a problem. In particular, liberal professions remain heavily regulated, while Austria has launched consultations on streamlining the rules and aligning them with European competition law.

Overall, the liberalisation of the network industries has proceeded and has led to a drop in mark-ups. In the energy sector, the electricity retail prices net of taxes stayed below the European average, despite a relative increase in 2004. However, the network access costs for electricity retailers ranked among the highest in Europe. This is an indication for low retail margins, and in October 2004 the only foreign electricity retailer active in Austria announced to shut down its operations.

... and the resources of the Federal Competition Agency increased slightly.

In the second year of its existence the Federal Competition Authority (FCA) has continued successfully to build up a public record of its activities. The staff of the competition authority increased slightly. However, the staffing problem seems to persist. Nevertheless, the Austrian competition system foresees a distribution of tasks between the FCA and the Cartel and the Supreme Cartel Courts, which are the two decision making bodies in cartel affairs. The law on telecommunications adopted in August 2003 strengthened the position of the telecommunication authority.

Table 18.1: Economic indicators for Austria

	Austria				EU-25			
	2001	2002	2003	2004	2001	2002	2003	2004
General economic background								
Real GDP growth ¹	0.7	1.2	0.8	1.9	1.8	1.1	1.0	2.5
Inflation ²	2.3	1.7	1.3	2.1	2.5	2.1	1.9	2.2
Labour productivity growth ³	0.3	1.1	0.7	1.4	0.8	0.9	0.9	2.1
Employment growth ¹	0.4	0.1	0.0	0.5	1.0	0.3	0.3	0.4
Nominal wage growth ⁴	1.4	1.7	2.1	2.5	4.0	3.2	3.1	3.0
Current account ⁵	-0.4	2.5	1.5	1.9	:	:	:	:
Unemployment ⁶	3.6	4.2	4.3	4.2	8.5	8.9	9.1	9.1
Public finance								
General government balance ⁵	0.3	-0.2	-1.1	-1.3	-1.2	-2.3	-2.8	-2.8
Primary balance ⁵	3.7	3.0	1.9	1.7	2.4	1.0	0.3	0.2
Cyclically-adjusted balance ⁵	0.0	-0.2	-0.8	-1.0	:	:	:	:
Gross government debt ⁵	66.1	65.7	64.5	64.0	62.1	61.6	63.2	63.5
Employment								
Employment rate ⁷	68.5	68.7	69.0	:	62.8	62.9	63.0	:
Female employment rate ⁸	60.7	61.3	61.7	:	54.3	54.7	55.1	:
Employment rate for older workers ⁹	28.9	29.1	30.1	:	37.4	38.8	40.2	:
Long-term unemployment ¹⁰	0.9	1.1	1.2	:	3.8	3.9	4.0	:
Tax rate on low wage earners ¹¹	39.7	39.9	40.2	:	37.2	37.1	37.4	:
Unemployment trap indicator ¹²	74.8	72	75.1	:	78.8	78.5	78.3	:
Product market reforms								
Hourly labour productivity ¹³	101.1	100.0	99.8	:	:	:	:	:
Total trade to GDP ratio ¹⁴	51.8	51.3	51.3	:	:	58.8	57.2	:
Internal Market Directives ¹⁵	97.1	97.1	97.5	97.8	:	:	:	96.3
Business investment ¹⁶	20.8	19.5	20.3	:	17.9	17.2	16.8	:
Knowledge-based economy								
Total tertiary graduates ¹⁷	26.6	:	:	:	46.8	:	:	:
Spending on human resources ¹⁸	5.7	:	:	:	5.1	:	:	:
R&D expenditure ¹⁹	2.1	2.2	2.2	2.3	1.9	1.9	:	:
Expenditure on IT ²⁰	3.1	2.9	2.9	2.9	3.1	2.9	2.9	2.9

¹ Growth rate in percentage.

² Annual average rate of change in harmonised index of consumer prices in percentage.

³ Growth rate of real GDP per occupied person in percentage.

⁴ Growth rate of compensation per employee.

⁵ As a percentage of GDP.

⁶ Number of unemployed as a percentage of the labour force.

⁷ Employed persons aged 15-64 as a share of the total population of the same age group.

⁸ Employed women aged 15-64 as a share of the total female population of the same age group.

⁹ Employed persons aged 55-64 as a share of the total population of the same age group.

¹⁰ Long-term unemployed (over 12 months) as a percentage of the total active population aged 15-64.

¹¹ Income tax plus employer/employee contributions as a percentage of labour costs of a single earner at 67% of the Average Production Worker-wage, no children.

¹² Effective tax rate on labour income taking into account the combined effect of increased taxes and benefits withdrawal as an individual moves from unemployment back to work earning 67% of the Average Production Worker-wage, measured at the first month of unemployment (after any 'waiting period' if applicable).

¹³ GDP per hour worked in PPS, EU-15=100.

¹⁴ Percentage, average value of imports and exports of goods and services divided by GDP, multiplied by 100. For DE, ES, FR, IT, PL and the UK the value for EU-25 is the total for the large Member States, for all the other states the value for EU-25 is the total for the small Member States.

¹⁵ Percentage implemented in November 2004.

¹⁶ Gross fixed capital formation by the private sector as a percentage of GDP.

¹⁷ Total tertiary graduates (ISCED 5-6) per 1000 of population aged 20-29.

¹⁸ Public expenditure on education as a percentage of GDP.

¹⁹ GERD Gross domestic expenditure on R&D as a percentage of GDP.

²⁰ Expenditure on information technology as a percentage of GDP.

Source: Commission services (incl. Eurostat, structural indicators)

The data for 'general economic background' and 'public finance' are taken from the Commission's Autumn 2004 Economic Forecasts.

19. POLAND

Introduction

After two years of slow growth in 2001 and 2002, the Polish economy is experiencing a strong recovery. The upswing gradually gained strength, and real GDP growth accelerated to close to 6 per cent in 2004. Despite robust growth, the labour market situation has little improved so far, underscoring the structural nature of Polish unemployment. With almost 50 per cent of the working age population out of work and an unemployment rate close to 19 per cent of the labour force, improving the functioning of the labour market remains of paramount importance. In spite of favourable cyclical conditions, no progress towards fiscal consolidation was made last year. However, a large number of measures outlined in the authorities' public finance reform package (Hausner plan) were adopted in the course of 2004 and will start being implemented in 2005. In particular, the reform of the tax and benefit system should pave the way for reducing the inactivity traps that hamper labour market adjustment. Important risks remain stemming from the rising stock of contingent liabilities. Despite a steady productivity growth, productivity levels per person employed are still relatively low. Moreover, the Polish economy shows a relatively weak innovation and absorption capacity for capital, technological and organisational progress, although many initiatives have been taken to adapt the education and training system accordingly. Also, considerable efforts have been made to reduce the administrative burden and to improve the business environment. However, the State continues to hold an important share of the economy and the privatisation process lacks public support. A detailed assessment of recent developments in addressing Poland's key policy challenges is presented in the following sections.

1. Labour market

Urgently address the deep-seated structural problems in the labour market

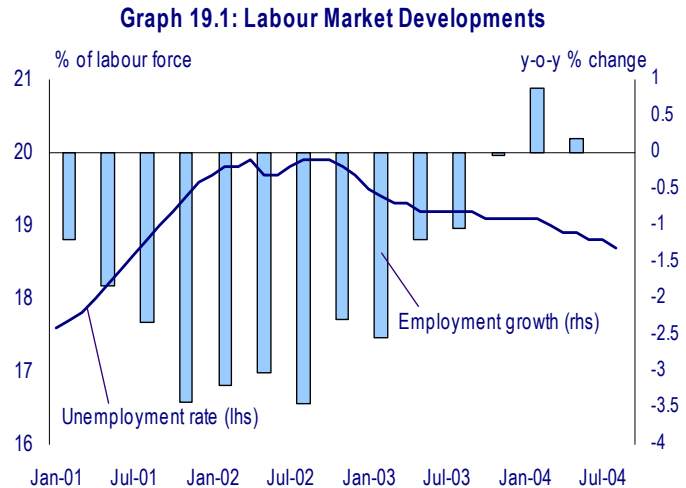
Under this challenge, Poland was requested to:

1. increase the flexibility of the wage-setting process to ensure that wages better reflect differences in productivity across skills, firms and regions (GL 5);
2. lower the tax burden on labour, together with efforts to widen the tax base on labour and to improve the efficiency of the tax collection and enforcement system, and reform the tax and benefit systems to eliminate financial disincentives to work, in particular high inactivity traps for married couples, and to increase the efficiency of social spending (GL 4); and
3. strengthen labour supply by pursuing efforts to better adapt the qualifications of the workforce to the requirements of the labour market and by removing obstacles to regional mobility, especially through reforms of the housing market and improvements in transport infrastructure (GL 7 and 13).

The lack of wage flexibility remains an acute problem...

Poland has a fairly decentralised wage bargaining system which should in principle be conducive to a flexible adjustment of wages to productivity developments, at least in the private sector. Nevertheless, there is evidence that greater wage differentiation is needed to better reflect differences in productivity across skills, firms and regions. The lack of wage flexibility in Poland is mainly linked to the existence of a nationally-set minimum wage. Indeed, the minimum wage is high relative to average wages in many regions, especially regions with large proportions of low-skilled workers, and as a result, it is a strong impediment to the wage flexibility at the lower end of the wage distribution. In order to improve employment prospects for young and low-skilled workers, it would be desirable to

make the minimum wage less binding. A first step in this direction was taken with the introduction of a time-limited scheme allowing firms to pay job starters or workers who did not work in the past two years, 80 per cent of the minimum wage in the first year of a new job and 90 per cent during the second year. However, the scope of this measure remains limited and 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 unskilled workers.



... but efforts are underway to reduce the disincentives to work associated with the current tax and benefit system

The authorities adopted last year, or are considering, a number of initiatives outlined in the Hausner plan (“Programme of Rationalisation and Reduction of Public Spending” approved by the government in January 2004), and designed to reduce the inactivity traps associated with the current benefit systems. However, compared to initial plans, some of the proposals have been watered down or abandoned, such as the reform of the disability pension system and the phasing-out of the early-retirement pension scheme. The measures incorporated in the draft budget for 2005 include steps to limit inflows into the pre-retirement programmes and reduce their disincentive effects (via the reduction of benefits), new rules for sickness benefits and family allowances, as well as changes in the farmers’ special social security system (increase in contributions). While these measures will contribute to increasing somewhat work incentives, they need to be complemented by more substantial reforms. By contrast, no progress was made in lowering the high tax burden on labour, and some of the measures envisaged, such as the increase in social security contributions for self-employed, would go in the wrong direction.

While several initiatives have been taken to improve the education and training system, little progress has been made in removing barriers to labour mobility

Regional differences in employment and unemployment could be reduced by increasing labour mobility. Low geographical mobility in Poland results mainly from a shortage of accommodation, high housing costs, and a lack of transport infrastructure as well as cultural factors. In order to facilitate the purchase of housing, the authorities intend to give access to preferential mortgage loans through a state-owned bank, BGK. Plans to improve the regional passenger transport network should contribute to reducing the unwillingness of workers to take up jobs outside their area of residence. In addition, the law on employment promotion adopted in April 2004 provides for mobility grants for certain groups of persons. While these measures are welcome, they would need to be supplemented by additional steps to improve the functioning of the housing market and remove transport barriers to mobility.

A comprehensive reform of the education system was launched in September 1999 in order to increase overall education levels and better adapt the skills of the workforce to the requirements of the labour market. The authorities pursue the implementation of the reform which is spread over a period of eight years. Moreover, a series of measures was adopted last year to encourage participation in continuing training (see below). The government has also announced its intention to introduce a law imposing compulsory training cycles within firms.

2. Public finances

Ensure a reduction of the general government deficit on a sustainable basis and the long-term sustainability of public finances

Under this challenge, Poland was requested to:

4. reduce the general government deficit in a credible and sustainable way within a multi-annual framework in line with the decisions to be taken by the Council in the context of the forthcoming budgetary surveillance exercise (GL 1 and 2); and
5. monitor the implementation of the reform of the pension system to counter the expected increase in the old-age dependency ratio, and take measures to reduce the fiscal risk stemming from the rising stock of contingent liabilities (GL 15 and 16).

Fiscal consolidation helped by stronger growth...

On 5 July 2004, the Council decided that Poland was in excessive deficit and recommended that this be corrected by 2007 at the latest. Specifically, Poland was required to implement with vigour the measures envisaged in the May 2004 convergence programme, in particular those contained in the Hausner plan, and to take effective action by 5 November 2004 regarding the measures envisaged to achieve the 2005 deficit target. In addition, the Council invited the Polish authorities to allocate possible extra revenues to decrease the general government deficit and to ensure that the rise in the debt ratio is brought to a halt.

The invitation to use extra revenues for deficit reduction was followed in 2004. The deficit target was revised downwards to 5.4 per cent of GDP from 5.7 per cent in the May 2004 convergence programme, while the growth forecast for 2004 was revised upwards from 5 per cent to 5.7 per cent. The draft budget for 2005, adopted by the government at the end of September, incorporates an important number of measures contained in the Hausner plan. These measures will rationalise and retrench public expenditure and increase revenue in 2005 in the following domains: (i) the State and its administration; (ii) some inefficient sectors in the economy and (iii) social policy. They will continue having a positive budgetary impact in 2006. Overall, the authorities expect the general government deficit to decline to 3.9 per cent of GDP in 2005 and 3.1 per cent in 2006 compared to respectively 4.2 per cent and 3.3 per cent of GDP in the convergence programme. Based on no-policy change assumptions, the Commission services forecasts are closer to the initial targets for 2005. In both years, fiscal adjustment is expected to be helped by the favorable cyclical conditions.

The strong debt dynamics came to a halt. The foreseen privatization revenues for 2004 materialized thanks to the privatization of the biggest Polish state-owned bank. The debt-to-GDP ratio forecasts for 2004 and 2005 were revised downwards also as a result of the decreasing borrowing needs of the public sector.

...but still important risks stemming from the rising stock of contingent liabilities

Contingent liabilities still constitute a risk to the sustainability of public finances. The outstanding debt of the health-care system continues to grow and expectations for a bail-out by the government are rising. The law on the reform of the health-care units (ZOZ) that would allow tackling the issue of their indebtedness was sent to Parliament at the beginning of 2004 with no follow-up. The profitability in the mining sector improved in 2004 due to higher coal prices on international markets and progress in restructuring, thus limiting potential recourse to state financing. Railways are being decentralised and regional firms take over some activity segments decreasing the pressure on the general government budget.

As the financial capacity of the central government budget is limited, a tendency is observed to decentralize education, health care, transport but also innovation and R&D expenditure to the local governments without, however, putting in place a thorough monitoring system⁸.

The pension reform was implemented in 1999. The system is stable and under constant monitoring. While the plan to equalize the retirement age of men and women has been abandoned, new steps are envisaged to encourage those who want to work longer and accumulate more pension rights.

3. Productivity and knowledge-based economy

Improve condition for increasing productivity

Under this challenge, Poland was requested to:

6. pursue and reinforce efforts to improve the efficiency and quality of the education and training system and its responsiveness to changing skills requirements (GL 13); and
7. promote R&D and innovation, in particular in the business sector, and support the transfer of knowledge through FDI (GL 13).

Many initiatives have been taken to adapt the education and training system to the labour market requirements...

The Law of 20 April 2004 foresees instruments to promote investment in training for employees and lifelong learning, such as the creation of training fund devoted to financing and co-financing of training. Changes in the general education programme have been introduced to develop the entrepreneurial potential at different level of education including in secondary schools. The strategy ePoland for the years 2004-2006 (including among others a broadband access strategy and internet at schools) was adopted in January 2004.

...but the still weak innovative capacity impairs the competitiveness of the Polish economy

In December 2003, the pilot programme of SME productivity and quality improvement by using IT was launched. The aim of this programme is to improve the transfer of knowledge by using IT in a chosen sample of pilot enterprises. The Ministry of Science and Information Technology also developed a system of targeted projects in order to spur the implementation of R&D results in the economy (7 per cent of the budget is dedicated to the implementation of this aim). Nevertheless, the share of innovative companies with respect to the total number of companies was halved from the period 1994-1996 to the period 1998-2000. In 2003, Poland's expenditure in IT as a percentage of GDP was 2.2 per cent, compared to the EU-15 average of 3 per cent. Total R&D expenditure amounted to 0.56 per cent of GDP with only 1/3 financed by industry. As far as FDI is concerned, compared with 2002, they show a general downward trend over the recent period, with an increase in greenfield FDI and a decrease in FDI associated with privatization. There is also evidence that companies with foreign capital increased their share in Polish exports, pointing at their international competitiveness compared to companies with Polish capital only.

⁸

Data about the budgetary situation of the local governments are published very late in the process of fiscal reporting.

4. Restructuring of the economy

Speed up the restructuring of the economy and accelerate privatisation in industry

Under this challenge, Poland was requested to:

8. reduce the overall level of State aids, whilst reorienting aid towards horizontal objectives (GL 9 and 14); and
9. encourage market entry and effective competition in network industries while pursuing a greater connectivity of national markets (GL 9).

No substantial reorientation of State aid hampering the economic restructuring ...

In order to comply with the EU *acquis* many changes in the procedure and scope of State aid have been implemented. Improvements in the data transparency and the monitoring of granted aid have been introduced. However, the amount of aids granted has increased as a result of the government anti-crisis activity package in 2003. No reorientation towards horizontal aid was observed with 92 per cent of aid being sectoral (80.5 per cent for coal mining).

...and the privatization process is resuming but a lot still needs to be done to develop effective competition in a number of sectors of the economy

After a slowdown in 2002-2003 due to unfavourable world economic conditions and to the lesser attractiveness of the remaining assets, the Polish Treasury has resumed with a more active privatization policy. Plans have been announced to accelerate the pace of privatization in 2005, among others, electricity, oil and gas sectors, although the strategy of restructuring, merging state-owned firms and consolidating the sectors (steel, mining and energy sector) before sale slows down the process. Energy prices are still regulated by the state. Regarding telecommunications and in accordance with the EU regulations, the Telecommunication law amendment continued the process of increasing competition, which should result in a fall in prices. Similarly, Poland has taken the necessary steps to comply with the EU *acquis* as regards postal services and competition is increasing in the courier service market.

5. Business dynamism

Strengthen the development of effective competition in some sectors

Under this challenge, Poland was requested to:

10. continue reducing administrative burden, simplifying regulation and supporting the growth of SMEs, in particular, by improving access to finance (GL 11).

The legislative steps are taken... but the implementation is considerably delayed.

The Law on Freedom of Economic Activity was adopted on July 2, 2004. The law should, among other things, reduce the administrative burden for business (simplified registration, reducing the number of licences, decreasing controls) and introduce the provision on binding interpretation of the law (from January 2005). The amendment of the Law on the National Criminal Register should also quicken the registration process. However, the registration at the “one-stop-shop” will only be possible in 2007. The level of business investment in 2003 was 14.9 per cent, below the EU average. Venture capital is also relatively low. Some remaining barriers still hinder entrepreneurship: among others, lack of infrastructure, high prices of telecom, weak incentive packages in comparison to other EU countries, a relatively high administrative burden and lack of transparency of the tax system.

Table 19.1: Economic indicators for Poland

	Poland				EU-25			
	2001	2002	2003	2004	2001	2002	2003	2004
General economic background								
Real GDP growth ¹	1.0	1.4	3.8	5.8	1.8	1.1	1.0	2.5
Inflation ²	5.3	1.9	0.7	3.5	2.5	2.1	1.9	2.2
Labour productivity growth ³	1.7	3.7	5.0	6.0	0.8	0.9	0.9	2.1
Employment growth ¹	-0.6	-2.2	-1.2	-0.2	1.0	0.3	0.3	0.4
Nominal wage growth ⁴	13.3	2.0	5.0	4.7	4.0	3.2	3.1	3.0
Current account ⁵	-2.9	-2.6	-2.2	-2.6	:	:	:	:
Unemployment ⁶	18.5	19.8	19.2	19.0	8.5	8.9	9.1	9.1
Public finance								
General government balance ⁵	-3.1	-3.6	-3.9	-5.6	-1.2	-2.3	-2.8	-2.8
Primary balance ⁵	-0.8	-0.7	-0.8	-2.5	2.4	1.0	0.3	0.2
Cyclically-adjusted balance ⁵	:	:	:	:	:	:	:	:
Gross government debt ⁵	36.7	41.1	45.4	47.7	62.1	61.6	63.2	63.5
Employment								
Employment rate ⁷	53.4	51.5	51.2	:	62.8	62.9	63.0	:
Female employment rate ⁸	47.7	46.2	46.0	:	54.3	54.7	55.1	:
Employment rate for older workers ⁹	27.4	26.1	26.9	:	37.4	38.8	40.2	:
Long-term unemployment ¹⁰	9.3	10.8	10.7	:	3.8	3.9	4.0	:
Tax rate on low wage earners ¹¹	41.4	41.6	41.6	:	37.2	37.1	37.4	:
Unemployment trap indicator ¹²	77.4	75.1	73.8	:	78.8	78.5	78.3	:
Product market reforms								
Hourly labour productivity ¹³	:	:	:	:	:	:	:	:
Total trade to GDP ratio ¹⁴	29.5	31.3	35.6	:	30.1	29.2	28.7	:
Internal Market Directives ¹⁵	:	:	:	96.8	:	:	:	96.3
Business investment ¹⁶	17.2	15.4	14.9	:	17.9	17.2	16.8	:
Knowledge-based economy								
Total tertiary graduates ¹⁷	71.1	74.5	:	:	46.8	:	:	:
Spending on human resources ¹⁸	5.6	5.4	:	:	5.1	:	:	:
R&D expenditure ¹⁹	0.6	0.6	0.6	:	1.9	1.9	:	:
Expenditure on IT ²⁰	1.6	1.8	2.5	2.8	3.1	2.9	2.9	2.9

¹ Growth rate in percentage.

² Annual average rate of change in harmonised index of consumer prices in percentage.

³ Growth rate of real GDP per occupied person in percentage.

⁴ Growth rate of compensation per employee.

⁵ As a percentage of GDP.

⁶ Number of unemployed as a percentage of the labour force.

⁷ Employed persons aged 15-64 as a share of the total population of the same age group.

⁸ Employed women aged 15-64 as a share of the total female population of the same age group.

⁹ Employed persons aged 55-64 as a share of the total population of the same age group.

¹⁰ Long-term unemployed (over 12 months) as a percentage of the total active population aged 15-64.

¹¹ Income tax plus employer/employee contributions as a percentage of labour costs of a single earner at 67% of the Average Production Worker-wage, no children.

¹² Effective tax rate on labour income taking into account the combined effect of increased taxes and benefits withdrawal as an individual moves from unemployment back to work earning 67% of the Average Production Worker-wage, measured at the first month of unemployment (after any 'waiting period' if applicable).

¹³ GDP per hour worked in PPS, EU-15=100.

¹⁴ Percentage, average value of imports and exports of goods and services divided by GDP, multiplied by 100. For DE, ES, FR, IT, PL and the UK the value for EU-25 is the total for the large Member States, for all the other states the value for EU-25 is the total for the small Member States.

¹⁵ Percentage implemented in November 2004.

¹⁶ Gross fixed capital formation by the private sector as a percentage of GDP.

¹⁷ Total tertiary graduates (ISCED 5-6) per 1000 of population aged 20-29.

¹⁸ Public expenditure on education as a percentage of GDP.

¹⁹ GERD Gross domestic expenditure on R&D as a percentage of GDP.

²⁰ Expenditure on information technology as a percentage of GDP.

Source: Commission services (incl. Eurostat, structural indicators)

The data for 'general economic background' and 'public finance' are taken from the Commission's Autumn 2004 Economic Forecasts.

20. PORTUGAL

Introduction

The economic downturn in Portugal bottomed out in 2003, when real GDP fell by 1.2 per cent. In 2004, the economy picked up, growing by close to 1 per cent. In 2005, growth is set to come closer to the euro-area average, after having lagged behind for three years. The turnaround in both private consumption and investment was the main driver of the recovery in 2004, although export growth also surprised on the positive side. Budgetary consolidation has been the core concern of the Portuguese economic policy since 2002. In order to avoid an overly restrictive stance during the recession, the government relied strongly on revenues from one-off measures to keep the general government deficit below the 3 per cent of GDP ceiling. These measures, which in 2004 amounted to 2.2 per cent of GDP, are to be gradually phased out as soon as the structural reforms that are currently being implemented start yielding the expected expenditure savings. Portugal has been reforming its health system and the pension scheme for government workers in order to ensure the long-term sustainability of public finances in face of the expected population ageing. The 2004 productivity and business dynamism policy developments in Portugal were to a large extent the continuation of initiatives of previous years, reflecting the fact that the electoral mandate was entering its second half. Efforts have continued particularly in terms of network industries liberalisation and promotion of education. The deep-rooted nature of the problems Portugal has to overcome, particularly in terms of low human capital endowments and low labour productivity per hour, have to be taken into account when assessing policy results. Nevertheless, worries remain about the general efficiency of the educational system. A detailed assessment of recent developments in addressing Portugal's key policy challenges is presented in the following sections.

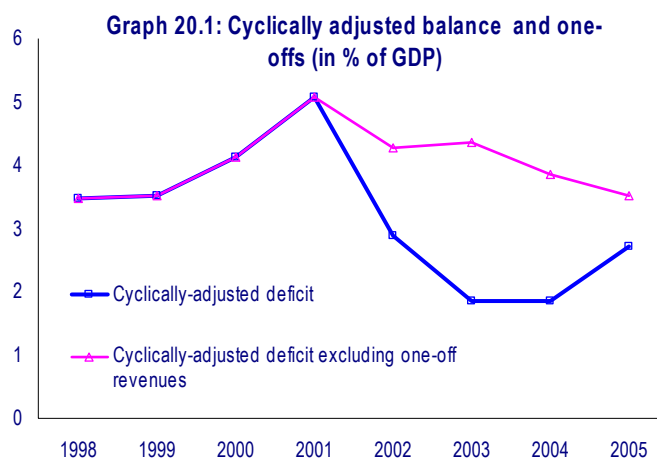
1. Public finances

Accelerate the consolidation of public finances and address the strong dynamics of Government expenditure	Assessment
Under this challenge, Portugal was requested to:	
1. take appropriate measures to avoid that the deficit breaches the 3 per cent of GDP reference value again; move towards achieving 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 per cent of GDP per year, replacing one-off measures by measures of a more permanent character (GL 1);	Limited
2. ensure that the deficit reduction is obtained mainly through the expenditure side by firmly executing budgetary plans for all sub-sectors of the general government (GL 14); and	Insufficient
3. undertake structural reforms in areas with a more direct impact on budgetary consolidation, notably in public administration, education, health-care, and social security.	In progress
Bearing in mind the three-year period available for implementation, the degree of implementation since 2003 is indicated as: "Complete" for (practically) complete; "In progress" where progress is well advanced; "Limited" where the recommendation is only partially addressed and "Insufficient" where no substantial measures going in the right direction have been taken.	

One-off measures have once again kept the general government deficit below 3 per cent of GDP

After a general government deficit of 2.8 per cent of GDP in 2003, Portugal benefited in May 2004 from an abrogation of the excessive deficit procedure that had been launched in November 2002. The general government deficit amounted to 2.9 per cent of GDP in 2004. In both 2003 and 2004, deficit figures below 3 per cent of GDP were achieved through the raising of sizeable revenues from one-off operations, worth 2.5 per cent and 2.2 per cent of GDP, respectively. Therefore, the underlying deficits were 5.3 per cent of GDP in 2003 and 5.1 per cent in 2004. In 2003, the recession caused a massive shortfall in tax revenue. In 2004, fiscal revenues were above expectations amid a stronger-than-expected internal demand recovery; however, a slippage on public expenditures hindered a stronger budgetary improvement. Since without further measures the deficit would have clearly exceeded 3 per cent of GDP, the Portuguese government introduced one-off operations in the course of 2004: the transfer to the general government sector of pension liabilities for four state-owned enterprises, which raised proceeds equal to 2.2 per cent of GDP.

The cyclically-adjusted headline deficit remained unchanged at 1.9 per cent of (actual) GDP in 2004. However, taking into account the lower revenues from one-off measures, the “underlying” cyclically-adjusted deficit is estimated to have fallen from 4.4 per cent of GDP in 2003 to 4.1 per cent in 2004. Despite this improvement, Portugal has made only limited progress with regard to the recommendation that called for a further improvement in the cyclically-adjusted budget



balance towards a position of close to balance. The replacement of one-off operations by measures of a more permanent character is not proceeding as fast as desirable for consolidation of public finances in the medium-term. In light of the Portuguese authorities' 2005 budget and the Commission's Autumn 2004 Economic Forecasts, continued strong reliance on revenues from one-off measures will be needed in order to keep the deficit below 3 per cent in 2005.

Current primary expenditure growing more strongly than expected...

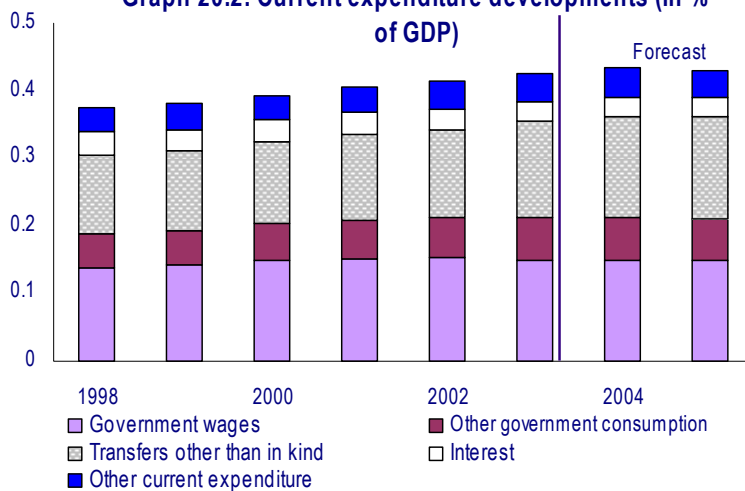
After a deceleration of the annual growth rate of current primary expenditure from 7.3 per cent in 2002 to 4.2 per cent in 2003, no further improvement was achieved in 2004. Against a targeted increase of 3.1 per cent in the budget for 2004, current primary expenditure is estimated to have gone up by around 5 per cent, largely due to slippages on health and old-age pension expenditures.

For 2005, the Portuguese authorities envisage some moderation in current expenditure growth. However, such expectation may turn out too optimistic, in particular with regard to direct transfers to families, of which expenditure on old-age pensions represents nearly half. The forces behind the expansion of pension expenditure remain strong: first, the phased convergence of pensions to the minimum wage; second, the ongoing population ageing; and, third, the maturing of pension schemes, which is reflected in higher average replacement ratios for the new pensioners due to longer work careers. All in all, expenditure on pensions

is projected to grow above nominal GDP and unless a strong decrease in unemployment benefits occurs, due to a stronger-than-expected recovery of the labour market, so will social transfers overall.

In 2004, the budgetary execution revealed expenditure levels in excess of the budgetary targets in the various sub-sectors of the general government. The expenditure slippage was particularly notorious in the “state” sub-sector, which has thus jeopardized a further deficit reduction. The situation of the “social security” sub-sector was characterized by a significant reduction of the surplus, while, despite the slippages, the sub-sectors “local and regional government” and “autonomous funds and services” likely moved from deficits to, respectively, situations of close balance or in surplus.

Graph 20.2: Current expenditure developments (in % of GDP)



...and the effects of structural reforms still to materialise

The programme of structural reforms extends over several important policy areas, including all those with significant budgetary impact, such as public administration, education, health-care, and old-age pension schemes. These reforms aim at supporting the process of budgetary consolidation by moderating public expenditure growth to a sustainable path, and enhancing the growth potential of the economy. The major steps had already been launched in late 2002 and 2003, and 2004 was mainly a year of fine-tuning the implementation of some measures or extending the coverage of others, such as the restructuring of the primary-school network. Building also on the review of the 2004 Implementation Report, there is evidence that the implementation of reforms has proceeded broadly in line with plans. Since most of the concerned measures will have lagged effects, the evidence of their effects on public sector efficiency and on the budget is still somewhat short for a comprehensive assessment. Moreover, the Portuguese authorities have recently re-stated their commitment to proceed as planned with the ongoing reforms for the year 2005.

2. Productivity and business dynamism

Increase overall competitiveness, which is at risk from the low efficiency of the education system, low R&D spending, a low degree of competition in certain sectors, and high nominal wage growth	Assessment
Under this challenge, Portugal was requested to:	
4. promote the stronger involvement of the business sector in R&D spending and innovation (GL 13), together with higher ICT take-up;	In progress
5. improve the efficiency of spending in education with a view to, inter alia, raising the qualification of human resources (GL 13), and reducing substantially the number of early school-leavers with insufficient levels of schooling or training;	Limited
6. enhance effective competition in liberalised utilities, especially in the energy sector, and create a better competitive environment by increasing the transposition rate of internal market directives (GL 9); and	Limited
7. encourage the social partners to secure wage moderation, while allowing wage increases to take into account productivity and skill differentials, with a view to improving competitiveness (GL 3 and 5).	Limited

The strategy initiated last year to encourage the transition towards a knowledge based society has continued to be implemented...

Portugal is below EU average in terms of business R&D, patents and take-up of ICT. Therefore fostering innovation and technological diffusion has continued to be a priority for the government. A new *Science and Innovation Action Plan* is due to be implemented soon. Its main guidelines are to continue to foster public investment in R&D, increase training investment in science and technology while promoting scientific employment, reinforce the fiscal incentives for private R&D and support for start-ups of innovative enterprises. Further support will be given for cooperation projects between businesses sector and R&D institutions aiming to disseminate innovation throughout the corporate sector.

The promotion of IT use through the *Portuguese Information Society Strategy* is starting to show visible results. Access to the internet has been consistently rising and the broadband penetration rate quasi doubled between 2003 and 2004 (but from a low level). Additional public administration initiatives contributed to the diffusion of IT like the Citizen's portal launched in 2004 to provide electronic access to various public services. The adoption of IT-based practices by the business community has been promoted by the transposition into national law of the EU directive that regulates electronic commerce. Legislative reforms have also been implemented to allow and regulate the use of electronic documents.

...but human capital endowment remains very low

While there has been substantial progress in terms of increasing the number of graduate and postgraduate students, important human capital insufficiencies remain, hindering the transition to a knowledge-based society. Education attainment levels are still the lowest among EU Member States with the exception of Malta. The efficiency of the education policy remains a concern. While Portugal has consistently spent higher shares of GDP on education than the EU average, the percentage of early school leavers was still the second highest in the EU. Reforms to the education system have continued to be implemented to modernise curricula and promote the use of IT and vocational education. A new *Plan for the Prevention of School Drop-out* has been launched to cut early school leaving by half by

2010. The strategy includes the adoption of innovative education-training projects as well as initiatives such as the setting up of social support centres at schools to address the needs of disadvantaged students. In order to increase the fraction of the population involved in lifelong learning (still among the lowest in the EU), a new *Vocational Training Bill* was proposed by the Council of Ministers in 2004 to establish the legal framework for vocational training and set up the *National Vocational Training System*. This structure would create a national inventory of skills to better adjust the training supply to the needs of the population and employers.

Some competition enhancing reforms have been taken in liberalised utilities but effective competition is not yet secured

In telecommunications, where the incumbent firm still largely dominates, further competition-enhancing reforms have been enforced by the regulator, such as facilitating number portability. In the energy sector, fuel prices were liberalised in January 2004. The competition authority has recently advised the government to reduce barriers to entry in the sector, particularly by facilitating hypermarket firms' expansion of their networks of petrol distribution outlets. In the electricity sector, eligibility to freely choose the electricity supplier has been extended to all consumers from August 2004. However, prices of electricity and gas remain higher than the EU average. This could be offset with the creation of the Iberian electricity market (MIBEL) that the Portuguese and the Spanish governments announced for June 2005. The two governments committed to tackle the issues that were holding back this process, namely the harmonisation of regulation and tariffs and the improvement of network connections between the two countries.

Efforts have continued to improve business environment

The time necessary to set up a new business was shortened as the expansion of *Business Formalities Centres* continued while the formalities for winding up companies were simplified and made more efficient with the reform of the bankruptcy law. In March 2004, a new *Commercial Licensing Regime* was adopted to liberalise and simplify the requirements for granting licenses for opening new shops. The basic rate for corporate income tax was reduced and a tax deduction for investment in equipment and R&D was introduced in January 2004. However, the rate of transposition of Internal Market directives remains far from the objective and has decreased to 96.6 per cent.

Wages growing at a slower pace

Portugal has not changed its wage bargaining mechanisms towards ensuring that wages better reflect productivity and skills differentials. Wage developments over the last two years have been strongly influenced by the economic recession and the ensuing jump in unemployment. Government sector wages were nearly frozen in 2003 and 2004, while private sector wage increases slowed substantially from 2002 to 2003. The lagged effects of the downturn in 2003 helped to keep wage growth low throughout 2004. The end of the quasi-freeze of wages in the government sector in 2005, with nominal wage gains set to exceed 2 per cent, is likely to exert upward pressure in the private sector as well. However, the sizeable negative output gap should help to contain such pressure.

The implementation of a new labour code was finalized in mid-2004, replacing the previous different pieces of labour legislation by a single text. It is expected to enhance labour market adaptability, in particular by allowing for greater flexibility for some work arrangements. Changes in the sickness benefit scheme eliminated inconsistencies in the earlier provisions that provided disincentives for taking up work.

3. Long-term sustainability of public finances

Ensure the long-term sustainability of public finances in the face of population ageing	Assessment
Under this challenge, Portugal was requested to:	
8. increase the efficiency of the healthcare system by introducing a wide range of measures that strengthen market mechanisms and rationalise demand (GL 14); and	In progress
9. adopt further reforms to the pension system for workers in the general government sector to secure its long-term sustainability and in order to progressively align it with the pension regime for private sector workers (GL 16).	In progress

The reform in the health sector is proceeding as planned

As reviewed in the 2004 Implementation Report, Portugal launched in late 2002 the first steps of a major reform of its health sector. The main elements of the ongoing reform are: (i) the incorporation of public hospitals into state-owned enterprises; the units incorporated so far represent about a quarter of the Portuguese health system; (ii) a clear separation between financing and provision of health care; (iii) changes in the compensation to hospitals for medical services, with a move from coverage of operational losses to payments according to the services provided; (iv) changes of policy on medication, involving the promotion of generic drugs and the setting of ceilings for the reimbursement of drugs aligned with reference prices; and (v) higher fees for medical treatment.

In 2004, the implementation of the reform continued broadly in line with plans. An increase in services rendered by the incorporated hospitals was noticeable in 2004. However, at this stage, a comprehensive assessment of the efficiency and budgetary impact of these measures faces two constraints: changes in accounting procedures from a cash- to an accruals basis; and the short period of observation and hence the difficulty of disentangling the effects of the ongoing reform process from changes in demand directed to the incorporated units, or changes in waiting time for surgery. In 2005, a holding-type company will be set up to centralise the management of all incorporated hospitals, a measure that is expected to allow for better coordination between units and dissemination of best practices, and consequently, to enhance efficiency and costs savings. A reinforcement of the policy on the use of generic drugs is also intended.

The effects of reform of pension schemes will be lagged in time

In January 2004, changes to the rules governing the retirement and the assessment of pension rights of civil servants came into force. Withdrawal from active service before the official retirement age of 60 years has become more costly, even for those individuals with a “complete” working career (36 years). New pensioners’ benefits have been lowered by basing the assessment of the reference pension on wages net of social contributions rather than on gross wages. As already mentioned in the 2004 Implementation Report, the pension system for workers in the government sector is closed for those joining the civil service as of September 1993, who will be covered by the general pension scheme, which is less generous when compared with the government workers’ pension arrangement.

The measures introduced will ease the upward pressure on pension expenditure, although this effect on the long-term sustainability of public finances may to some extent be offset by the trend increase in life expectancy and the implicit extension of average benefit periods.

Table 20.1: Economic indicators for Portugal

	Portugal				EU-25			
	2001	2002	2003	2004	2001	2002	2003	2004
General economic background								
Real GDP growth ¹	1.6	0.4	-1.2	1.3	1.8	1.1	1.0	2.5
Inflation ²	4.4	3.7	3.3	2.4	2.5	2.1	1.9	2.2
Labour productivity growth ³	0.3	0.1	-0.8	0.9	0.8	0.9	0.9	2.1
Employment growth ¹	1.3	0.3	-0.4	0.4	1.0	0.3	0.3	0.4
Nominal wage growth ⁴	5.7	4.4	4.1	3.1	4.0	3.2	3.1	3.0
Current account ⁵	-10.1	-7.8	-5.7	-6.8	:	:	:	:
Unemployment ⁶	4.0	5.0	6.3	6.3	8.5	8.9	9.1	9.1
Public finance								
General government balance ⁵	-4.4	-2.7	-2.8	-2.9	-1.2	-2.3	-2.8	-2.8
Primary balance ⁵	-1.2	0.3	0.1	-0.2	2.4	1.0	0.3	0.2
Cyclically-adjusted balance ⁵	-5.1	-2.9	-1.9	-1.9	:	:	:	:
Gross government debt ⁵	55.8	58.4	60.3	60.8	62.1	61.6	63.2	63.5
Employment								
Employment rate ⁷	69.0	68.8	68.1	:	62.8	62.9	63.0	:
Female employment rate ⁸	61.3	61.4	61.4	:	54.3	54.7	55.1	:
Employment rate for older workers ⁹	50.2	51.4	51.6	:	37.4	38.8	40.2	:
Long-term unemployment ¹⁰	1.5	1.7	2.2	:	3.8	3.9	4.0	:
Tax rate on low wage earners ¹¹	29.5	29.6	29.6	:	37.2	37.1	37.4	:
Unemployment trap indicator ¹²	87.7	87	86.6	:	78.8	78.5	78.3	:
Product market reforms								
Hourly labour productivity ¹³	59.0	59.0	58.1	:	:	:	:	:
Total trade to GDP ratio ¹⁴	35.8	34.0	33.5	:	:	58.8	57.2	:
Internal Market Directives ¹⁵	97.5	96.9	97.8	96.6	:	:	:	96.3
Business investment ¹⁶	23.2	21.7	19.1	:	17.9	17.2	16.8	:
Knowledge-based economy								
Total tertiary graduates ¹⁷	37.9	40.3	:	:	46.8	:	:	:
Spending on human resources ¹⁸	5.9	5.8	:	:	5.1	:	:	:
R&D expenditure ¹⁹	0.9	0.8	0.8	:	1.9	1.9	:	:
Expenditure on IT ²⁰	2.2	1.9	2.0	2.0	3.1	2.9	2.9	2.9

¹ Growth rate in percentage.

² Annual average rate of change in harmonised index of consumer prices in percentage.

³ Growth rate of real GDP per occupied person in percentage.

⁴ Growth rate of compensation per employee.

⁵ As a percentage of GDP.

⁶ Number of unemployed as a percentage of the labour force.

⁷ Employed persons aged 15-64 as a share of the total population of the same age group.

⁸ Employed women aged 15-64 as a share of the total female population of the same age group.

⁹ Employed persons aged 55-64 as a share of the total population of the same age group.

¹⁰ Long-term unemployed (over 12 months) as a percentage of the total active population aged 15-64.

¹¹ Income tax plus employer/employee contributions as a percentage of labour costs of a single earner at 67% of the Average Production Worker-wage, no children.

¹² Effective tax rate on labour income taking into account the combined effect of increased taxes and benefits withdrawal as an individual moves from unemployment back to work earning 67% of the Average Production Worker-wage, measured at the first month of unemployment (after any 'waiting period' if applicable).

¹³ GDP per hour worked in PPS, EU-15=100.

¹⁴ Percentage, average value of imports and exports of goods and services divided by GDP, multiplied by 100. For DE, ES, FR, IT, PL and the UK the value for EU-25 is the total for the large Member States, for all the other states the value for EU-25 is the total for the small Member States.

¹⁵ Percentage implemented in November 2004.

¹⁶ Gross fixed capital formation by the private sector as a percentage of GDP.

¹⁷ Total tertiary graduates per 1000 of population aged 20-29.

¹⁸ Public expenditure on education (ISCED 5-6) as a percentage of GDP.

¹⁹ GERD Gross domestic expenditure on R&D as a percentage of GDP.

²⁰ Expenditure on information technology as a percentage of GDP.

Source: Commission services (incl. Eurostat, structural indicators)

The data for 'general economic background' and 'public finance' are taken from the Commission's Autumn 2004 Economic Forecasts.

21. SLOVENIA

Introduction

In 2004, the Slovene economy rebounded as exports expanded vigorously owing to the recovery in the EU, the main trade area for Slovenia. The prospects for good performance to endure over the medium term are solid. However, should the international environment fail to buoy adequate demand, economic activity might become strained due to the structural weaknesses as spelled out in the country-specific challenges. Structural adjustments are deemed essential to assure the long-term sustainability of the disinflation process, which has been identified as a policy priority, mobilising the principal government's efforts in 2004. It appears as though inflation remains well above the EU-average due to structural imperfections, particularly in the non-tradable sector. Furthermore, structural rigidities generate labour market shortcomings, confirmed by a slow progress in creating jobs despite some measures, taken to facilitate the participation of groups furthest from the labour market, such as older workers and long-term unemployed. The implementation of the reform programme, involving privatisation, liberalisation and production capacity restructuring, is limited. Slovenia has completed a number of reforms to promote entrepreneurship. Significant liberalisation has occurred in the network industries, however, State owned incumbents continue to dominate. Latest figures show that in 2003 FDI inflows were equal to 0.6 per cent of GDP, one of the lowest rates in the EU. A detailed assessment of recent developments in addressing Slovenia's key policy challenges is presented in the following sections.

1. Inflation

Strengthen the sustainability of the disinflation process

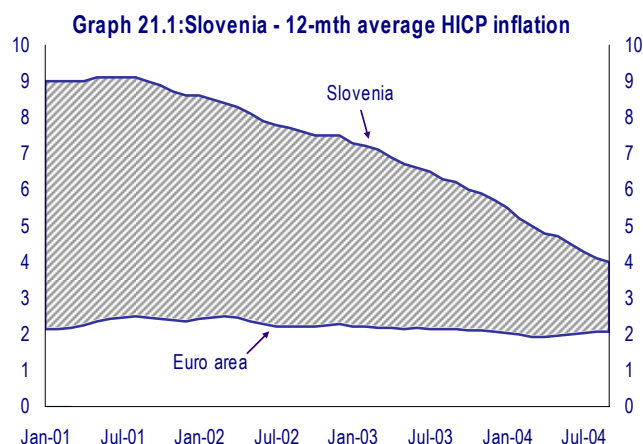
Under this challenge, Slovenia was requested to:

1. step-up structural reforms aimed at liberalising administered prices and advance further with de-indexation, in particular of the wage setting mechanism (GL 5).

Inflation has declined impressively but the sustainability of the disinflation process should be closely monitored.

Helped mostly by the concerted-policy action of the government and the national central bank, inflation continued to decrease rapidly in 2004. While the annual increase of consumer prices averaged 5.7 per cent in 2003, in November, the 12 month moving average of consumer price inflation stood at 3.8 per cent. The government regulated administered price rises and indirect tax changes in a way not to exceed the targeted inflation rate. Moreover, it applied frequent adjustments of excise duties on oil to temper the impact of world market price fluctuations. In pursuing the objective of dispensing with backward-looking wage indexation schemes, further progress was made in May 2004, when a new wage agreement was concluded in the private sector. Based on expected rather than actual inflation, it mirrors the adjustment method for public sector wages, negotiated in July 2003 to take effect in 2004-2005. The Bank of Slovenia contributed to the disinflation through monetary policy geared to slowing the depreciation of the currency. On 28 June, upon entering ERM II, the central parity rate was fixed at 239.64 dollars per euro within a +/- 15 per cent fluctuation band. A co-ordination of anti-inflationary policy measures has led to the sustained lowering of inflation, nevertheless, it remains substantially above the euro-zone levels.

Admittedly, it is not unacceptable that inflation in Slovenia would stay somewhat higher than the EU-average in the next few years as long as Slovenia's productivity growth on average outstrips productivity gains in the EU (the so-called Balassa-Samuelson effect). However, inflationary pressures persist due to structural rigidities. Liberalisation of the network industries is ongoing but some utilities are still operated in ineffective



competition conditions, wherein prices stay under different regimes of regulation. While containing price increases resulting from monopolistic behaviour in utilities such as electricity and gas would make sense, the extension of the list of regulated prices as of March 2004 could be perceived as a reduction of the commitment towards price liberalisation and competitiveness. Furthermore, part of the disinflation came about thanks to the lowering of indirect taxes, which affect headline inflation but have a limited impact on underlying inflation. Only if disinflation is accompanied by a removal of structural rigidities can it be sustainable in the long-run.

2. Labour market

Increase employment rates, especially for older workers

Under this challenge, Slovenia was requested to:

2. review the tax and benefit systems, with a focus on labour market participation of older workers, and reassess the measures promoting active ageing by means of lifelong learning activities, as well as address the imbalance between temporary and permanent work conditions (GL 4, 8).

Labour market reform proceeds in 2004 with important elements of the reform pending.

With a recent economic slowdown impinging on Slovenia's labour market, employment fell while unemployment increased. The authorities aimed to reduce labour costs by adapting the tax system. In September, the amended act on the payroll tax entered into force, raising the minimum threshold for payment of tax. Furthermore, certain provisions with respect to structural shortcomings, such as the low employment levels of older workers and the large share of long-term unemployment have been adopted. The measures are channelled through the tax system in a way to give employers the incentive to hire people furthest from the labour market. Employers have been awarded an exemption from paying social contributions for employing a worker aged over 55 years and are now granted a lump-sum subsidy when a long-term unemployed person is taken on. While some activities have been launched to facilitate access to lifelong learning, they would need to be embedded in a comprehensive active ageing strategy, including financial incentives and flexible working arrangements, to assure that the retirement age will increase notably. As regards the invitation to address the imbalance between temporary and permanent work conditions to avoid segmentation of the labour market, threatening also young workers, especially first-time job seekers, no measures were taken in 2004.

3. Productivity and business dynamism

Improve conditions for sustained productivity growth

Under this challenge, Slovenia was requested to:

3. further reduce the time and costs necessary to set up a new company and simplify the administrative procedures affecting businesses (GL 11); and
4. promote R&D and innovation in the business sector and improve the quality of the tertiary level education system (GL 13).

Some progress has been made to facilitate the creation of new businesses.

During 2004 Slovenia took positive steps to reduce the administrative barriers facing new businesses. These included passing two Acts of Parliament (the Act on the Support Environment for Entrepreneurship, and the Act on Revisions and Amendments to the Small Business Act) and the partial completion of the one-stop-shop service for small businesses. The effect of the Entrepreneurship Environment Support Act will be to strengthen the support network that exists to provide help and advice for entrepreneurs. The Act on Revisions and Amendments to the Small Business Act is designed to simplify the procedure for small businesses wishing to get the necessary licence to enter a particular market. The information and business support elements of the one-stop-shop system, which are already in place, allow small businesses to exchange information and to receive support and advice via a subsidised advisory system. Implementation has begun on the third element of the one-stop-shop system, which will allow the registration of a business to be carried out within 14 days. Other regulatory decrees, designed to eliminate unnecessary administrative barriers for small businesses are being drafted but have not yet been implemented. On a less positive note, many small and medium sized enterprises face problems getting access to capital from banks.

Positive steps have been taken to encourage businesses to invest in R&D.

At 1.5 per cent of GDP in 2003, Slovenia already has the highest R&D spending of the new Member States. 60 per cent of this spending comes from industry. In order to further encourage business R&D spending the Slovenian government passed in 2004 an Act of Parliament which grants tax incentives to companies investing in new equipment, with stronger incentives for those investing in equipment for research and technological development. The Act also gives substantial tax relief to companies who hire PhD graduates. This measure directly incentivises companies to hire highly qualified staff with backgrounds in research and may also indirectly incentivise more people to study for PhDs. Furthermore, 2004 saw the adoption of a decision to finance the establishment of eight to nine centres of excellence, co-financed by European structural funds, which are intended to provide a link between research institutions and industry. These links, combined with a focus on applied research, are important if returns on R&D expenditure are to be realised in terms of new products and services. In order to improve the quality of tertiary education two new laws were adopted in 2004, one on higher education and one on post-secondary education. These form part of Slovenia's efforts within the framework of the Bologna and Brugge-Copenhagen processes on tertiary education and training.

4. Competition

Promote the development of effective competition in all segments of the economy, notably in network industries

Under this challenge, Slovenia was requested to:

5. strengthen the administrative capacity of the Competition Protection Office, ease the entry of new competitors in network industries, and facilitate the purchase of lands for industrial use (GL 9).

The Competition Protection Office is still understaffed.

The Competition Protection Office (CPO) currently has 18 employees. There are plans to increase the staff to at least 37 but there is no clear timescale for the planned increases. Fines for anticompetitive behaviour are currently set by the courts, on the basis of a written proposal by the CPO. A new Act, which has yet to be enacted, will confer direct responsibility for issuing fines on the CPO. The level of fines will increase under the new Act but they remain well below the deterrent level fines that can be set in some other Member States.

Liberalisation of the network industries continues but at a different intensity across sectors.

Progress is being made in liberalising all of the main network industries, although some are far more advanced than others. In the telecommunication sector only the fixed line segment continues to lack competition, and even there a number of competitors to the incumbent have acquired operator licences although they have not yet entered the market. The proposed privatisation of the incumbent telecommunications operator has been delayed due to unfavourable market conditions. The legal unbundling of the Transport System Operators in electricity and gas represent significant steps towards increased competition although the Distribution System Operators are still currently unbundled only through separate accounting. Also the May 2004 amendments to the Energy Act, which allows non-household users to choose their electricity supplier, should increase competition and may lead to lower prices.

Limited progress being made on facilitating the purchase of land for industrial use.

In 2004 Slovenia started to use the EU structural fund co-financed subsidies for the renovation, modernisation and development of public and utility infrastructure. The aim is that redeveloped land and infrastructure will increase the supply of land for industrial use. Public tendering of real estate is the first stage in a long process and the benefits in terms of greater inward FDI are likely to still be some way off.

Table 21.1: Economic indicators for Slovenia

	Slovenia				EU-25			
	2001	2002	2003	2004	2001	2002	2003	2004
General economic background								
Real GDP growth ¹	2.7	3.3	2.5	4.0	1.8	1.1	1.0	2.5
Inflation ²	8.6	7.5	5.7	3.9	2.5	2.1	1.9	2.2
Labour productivity growth ³	2.2	3.7	2.8	3.8	0.8	0.9	0.9	2.1
Employment growth ¹	0.5	-0.4	-0.3	0.2	1.0	0.3	0.3	0.4
Nominal wage growth ⁴	11.6	10.0	7.8	6.0	4.0	3.2	3.1	3.0
Current account ⁵	0.2	1.4	-0.4	-0.2	:	:	:	:
Unemployment ⁶	5.8	6.1	6.5	6.3	8.5	8.9	9.1	9.1
Public finance								
General government balance ⁵	-2.8	-2.4	-2.0	-2.3	-1.2	-2.3	-2.8	-2.8
Primary balance ⁵	-0.4	0.0	0.1	-0.3	2.4	1.0	0.3	0.2
Cyclically-adjusted balance ⁵	:	:	:	:	:	:	:	:
Gross government debt ⁵	28.1	29.5	29.4	30.9	62.1	61.6	63.2	63.5
Employment								
Employment rate ⁷	63.8	63.4	62.6	:	62.8	62.9	63.0	:
Female employment rate ⁸	58.8	58.6	57.6	:	54.3	54.7	55.1	:
Employment rate for older workers ⁹	25.5	24.5	23.5	:	37.4	38.8	40.2	:
Long-term unemployment ¹⁰	3.5	3.4	3.4	:	3.8	3.9	4.0	:
Tax rate on low wage earners ¹¹	40.3	39.8	40.2	:	37.2	37.1	37.4	:
Unemployment trap indicator ¹²	80.5	80.5	80.5	:	78.8	78.5	78.3	:
Product market reforms								
Hourly labour productivity ¹³	:	:	:	:	:	:	:	:
Total trade to GDP ratio ¹⁴	58.0	56.9	56.4	:	:	58.8	57.2	:
Internal Market Directives ¹⁵	:	:	:	96.3	:	:	:	96.3
Business investment ¹⁶	21.5	20.5	21.1	:	17.9	17.2	16.8	:
Knowledge-based economy								
Total tertiary graduates ¹⁷	40.2	47.6	:	:	46.8	:	:	:
Spending on human resources ¹⁸	6.2	6.0	:	:	5.1	:	:	:
R&D expenditure ¹⁹	1.6	1.5	1.5	:	1.9	1.9	:	:
Expenditure on IT ²⁰	1.8	2.0	2.1	2.2	3.1	2.9	2.9	2.9

¹ Growth rate in percentage.

² Annual average rate of change in harmonised index of consumer prices in percentage.

³ Growth rate of real GDP per occupied person in percentage.

⁴ Growth rate of compensation per employee.

⁵ As a percentage of GDP.

⁶ Number of unemployed as a percentage of the labour force.

⁷ Employed persons aged 15-64 as a share of the total population of the same age group.

⁸ Employed women aged 15-64 as a share of the total female population of the same age group.

⁹ Employed persons aged 55-64 as a share of the total population of the same age group.

¹⁰ Long-term unemployed (over 12 months) as a percentage of the total active population aged 15-64.

¹¹ Income tax plus employer/employee contributions as a percentage of labour costs of a single earner at 67% of the Average Production Worker-wage, no children.

¹² Effective tax rate on labour income taking into account the combined effect of increased taxes and benefits withdrawal as an individual moves from unemployment back to work earning 67% of the Average Production Worker-wage, measured at the first month of unemployment (after any 'waiting period' if applicable).

¹³ GDP per hour worked in PPS, EU-15=100.

¹⁴ Percentage, average value of imports and exports of goods and services divided by GDP, multiplied by 100. For DE, ES, FR, IT, PL and the UK the value for EU-25 is the total for the large Member States, for all the other states the value for EU-25 is the total for the small Member States.

¹⁵ Percentage implemented in November 2004.

¹⁶ Gross fixed capital formation by the private sector as a percentage of GDP.

¹⁷ Total tertiary graduates (ISCED 5-6) per 1000 of population aged 20-29.

¹⁸ Public expenditure on education as a percentage of GDP.

¹⁹ GERD Gross domestic expenditure on R&D as a percentage of GDP.

²⁰ Expenditure on information technology as a percentage of GDP.

Source: Commission services (incl. Eurostat, structural indicators)

The data for 'general economic background' and 'public finance' are taken from the Commission's Autumn 2004 Economic Forecasts.

22. SLOVAKIA

Introduction

Slovakia's real GDP growth has increased over recent years and is expected to average close to 5 per cent over the period 2004 to 2006. Provided that second-round effects are kept in check, rapid disinflation from almost 8 per cent in 2004 should be possible, as the period of major adjustments in administered prices and indirect taxes basically came to a close. After a remarkable improvement in 2003, Slovakia's current account deficit is anticipated to stay close to 3 per cent of GDP. Against this favourable macroeconomic background, the government has intensified its actions to address the main economic policy challenges. Public finance reforms have been accelerated since 2003 and contribute to the sustainable reduction of the general government deficit, although the latter remains above the 3 per cent of GDP Treaty reference value. Efforts to tackle the structural shortcomings in the labour market have been stepped up, but these reforms seem to bear fruit only gradually: according to labour force survey data, the unemployment rate still amounts to around 18 per cent as economic restructuring, which has been underpinning Slovakia's growth performance, continues. Slovak labour productivity per person employed stood at 54.1 per cent of the EU-15 level. In terms of productivity growth, Slovakia enjoyed rather high rates of around 3.5 per cent over the last five years which has enabled the country to close somewhat the gap vis-à-vis the EU average. Slovakia has proceeded vigorously with structural reforms and has won the title of 'top reformer' from the World Bank. Despite these efforts weaknesses in the business environment persist, particularly in terms of law enforcement. Much still remains to be done to speed up the transition to the knowledge-based society. Education reform is only in its first stages and progress on R&D and innovation and transfer of knowledge, despite significant FDI inflows, has been limited. However, to address all these issues, the government has prepared a 'Competitiveness Strategy for Slovakia until 2010: National Lisbon Strategy' for approval in January 2005. Its main objective is to achieve a transition to the knowledge-based society by focusing government's policies on four main areas: human resources and education, information society, business environment and science, R&D and innovations. A detailed assessment of recent developments in addressing Slovakia's key policy challenges is presented in the following sections.

1. Public Finances

Ensure a further reduction of the general government deficit on a sustainable basis

Under this challenge, Slovakia was requested to:

1. reduce the general government deficit in a credible and sustainable way within a multi-annual framework in line with the decisions to be taken by the Council in the context of the forthcoming budgetary surveillance exercise (GL 1).

The deficit reduction path in the convergence programme is adhered to.

On 5 July 2004, the Council decided that Slovakia was in excessive deficit and recommended that this be corrected by 2007 at the latest. Specifically, Slovakia was required to implement with vigour the measures envisaged in the May 2004 convergence programme, in particular those related to the proposed further health care reforms and further public sector rationalisation. Slovakia was also required to accelerate the fiscal adjustment if the implemented structural reforms result in higher growth than expected.

The general government deficit target for 2004 of 4 per cent of GDP, as communicated in the May 2004 convergence programme, seems to have been reached with a comfortable margin. On the basis of current information, the budget outcome is estimated at 3.9 per cent of GDP.

The budget for 2005 adopted by the parliament in December last year and the associated detailed multi-annual budgetary framework for 2005 to 2007 are in line with the deficit reduction path as presented in the May 2004 convergence programme. The deficit target for 2005 is 3.8 per cent of GDP, marginally better than the 3.9 per cent of GDP in the convergence programme. It is 3.4 per cent of GDP without the revenue loss stemming from the introduction of a funded pension pillar. For 2006, the deficit target in the budget as well as in the convergence programme is 3.9 per cent of GDP (including 1 per cent of GDP resulting from the pension reform).

The budget 2005 incorporates the measures which underpinned the deficit target in the convergence programme, in particular: (1) a systemic pension reform, leading to a re-direction of social security contributions to a newly introduced funded pension pillar; (2) the last tranches of the current government's health care reform agenda; and (3) further public sector rationalisation. The Commission services autumn 2004 economic forecasts confirm that the macroeconomic projections underlying the 2005 budget are broadly plausible. They also confirm that the measures presented in the budget are broadly sufficient to achieve the 2005 deficit target set in the May 2004 convergence programme, although some uncertainties remain on the revenue side, including with respect to VAT revenues, social contributions and to the revenue effect of the pension reform.

Concerning the recommended acceleration of the fiscal adjustment if the implemented structural reforms result in higher growth than expected in the convergence programme, it seems that the authorities would have had some additional opportunities.

2. Labour market

Continue to address the deep-seated structural problems in the labour market

Under this challenge, Slovakia was requested to:

2. strengthen labour supply by removing obstacles to regional mobility and by reducing skill mismatches, whilst ensuring the efficiency of retraining measures and other active labour market policies (GL 4, 7 and 8);
3. generate additional labour demand by allowing for more flexibility in the wage setting mechanism (GL 5 and 18); and
4. lower the very high combined health and social contribution rates, while observing the overall budgetary consolidation constraints, in particular by additional health system reform measures and more effort to effective and functioning implementation of the new pension system combined with appropriate control (GL 4 and 16).

The government has been stepping up its efforts to strengthen labour supply,...

After a tightening of unemployment benefit rules already in 2003, further reforms in the social area, in particular regarding social assistance, became effective at the beginning of 2004 with a view to enhancing incentives to work and to leave the informal sector. In addition, the public employment services were reformed and joint offices for social and employment services were created to ensure more coherence in the administration of related categories of social benefits and assistance. Specific measures to dismantle obstacles to regional mobility and to reduce skill mismatches are being implemented: regional mobility is strengthened by financial support for commuters, by continued improvements in the transport infrastructure (including public transport) and by housing benefits and measures to improve the functioning of the housing market, which remains the core deficiency in this area. Skill mismatches are being tackled by active labour market policy measures, which have been intensified in 2004 and for which an evaluation methodology is under preparation. A reform of the education system is ongoing and encourages a more efficient and effective use of resources, e.g. through per-capita financing of schools.

...to generate additional labour demand,...

Improvements in the legal environment and the general business climate assist in strengthening incentives for job creation. They comprehend notably the enhanced implementation of a more flexible labour code effective since 2003, and efforts to further facilitate business start-ups and to further improve the judicial system. The government continues to be successful in the acquisition of sizeable foreign investments. Moreover, complementary to the efforts to foster regional mobility among the active population, the government is trying to strengthen the incentives for job creation in particular in regions affected by high unemployment. The direct influence of the government on wage setting is limited to minimum wages, which amounted to about 45 per cent of the average wage in 2003. Aware of potential disincentive effects, the government does not seem to have any intention to decrease the gap to the average wage. Furthermore, the government has continued to refrain from using the possibility of extending collective wage agreements to enterprises that have not participated in the negotiations. The government is actively advocating increased flexibility in work and wage arrangements. This and stronger incentives for outsiders to get a job should assist in mobilising pressure in this direction and help to promote greater space for flexibility, notably in collective wage agreements. Altogether, these developments are likely to cater for a more enterprise-specific differentiation in wage setting, although there remains further room for improvement.

... and to create the conditions for an affordable reduction in contribution rates.

The introduction of a flat corporate and individual income tax rate of 19 per cent at the beginning of 2004 is set to motivate both job creation and the willingness to work. To a similar effect, social contribution rates payable by employers were reduced by 3 percentage points from 38.2 per cent of gross wages. Nevertheless, the total health and social contribution rate remains at a very high level of 48 per cent of gross wages and it remains challenging to make a further reduction affordable. A substantial step in this direction was taken at the beginning of 2005 when a sizeable funded pension pillar (with contributions of 9 per cent of gross wages) was introduced – a reform that increases the sustainability of the pension system and could, in the medium and long run, make reductions of contributions possible. This systemic pension reform complemented earlier parametric reforms of the pay-as-you-go pillar that were adopted in 2003. They included a rise in the retirement age to 62 for both men and women, which is now successively implemented at a pace of an increase of 9 months per year. A further increase to 65 is contemplated, but only for the time after the current BEPG-horizon. In the health care area, the parliament has passed the last tranches of the government's comprehensive reform package. They became effective at the beginning of 2005 and add to earlier introduced reforms (e.g. co-payments for health services). The more recent reforms strengthen competitive elements, for instance through the reconfiguration of the health insurance system, and provide the basis for a streamlining of the benefit package. The reform measures should help to rein in health care cost, thereby strengthening the basis for an eventual, fiscally sound, reduction of health insurance contribution rates. The overarching constraint for reductions in both health and social insurance contributions remains the necessity of a strict adherence to and, if possible, acceleration of the deficit reduction currently envisaged by the authorities.

3. Business environment and entrepreneurship

Improve the business environment and support entrepreneurship

Under this challenge, Slovakia was requested to:

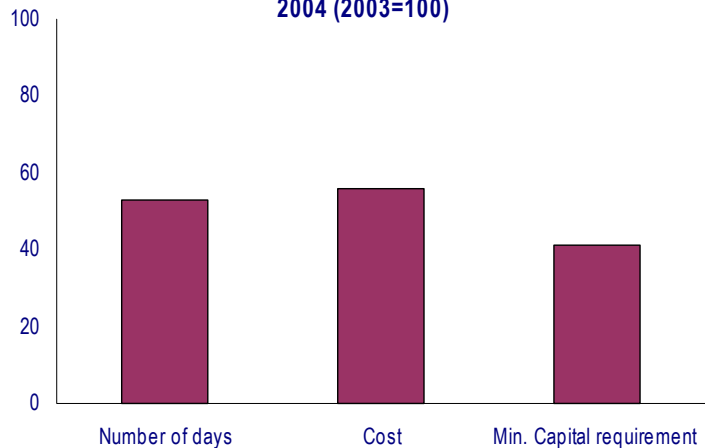
- strengthen the legislative framework supportive to entrepreneurship and improve its enforceability by, in particular, adopting the new bankruptcy legislation and increasing the capacity and transparency of the judicial system (GL 11 and 12).

Several measures have been taken to improve the business environment ...

There has been significant progress in improving the business environment in Slovakia. In order to improve the business environment the government aimed at enhancing both the legislative framework and its enforceability. As regards the former, the improved operation of the Commercial Register together with strict time limits for the other procedures required to set up a company have considerably reduced the overall time needed for the whole process. Further improvements (e.g. on-line communication with the Register, unified forms, one-stop-shops for entrepreneurs, on-line submission of tax declarations, and better transmission of information within the administration)

are foreseen. The new bankruptcy legislation, speeding up the bankruptcy procedures and allowing for more effective restructuring of troubled companies, is being discussed in the Parliament. The reform of the tax system led to a decrease in the corporate tax rate. As regards the latter, the government aims at improving the working of the judicial system. In order to speed up the proceedings and reduce the workload for the judges an institute of court administrators who are responsible for acts of an administrative nature has been introduced.

**Graph 22.1: Ease to start a business in Slovakia
2004 (2003=100)**



are foreseen. The new bankruptcy legislation, speeding up the bankruptcy procedures and allowing for more effective restructuring of troubled companies, is being discussed in the Parliament. The reform of the tax system led to a decrease in the corporate tax rate. As regards the latter, the government aims at improving the working of the judicial system. In order to speed up the proceedings and reduce the workload for the judges an institute of court administrators who are responsible for acts of an administrative nature has been introduced.

...but weaknesses persist and, in particular, weak enforcement remains a problem.

However, changes are taking root only slowly. The business sector still considers the efficiency of judiciary, law enforcement, the level of corruption and bureaucracy as major weaknesses.

4. Productivity

Improve conditions for increasing productivity

Under this challenge, Slovakia was requested to:

- improve the efficiency and quality of the education and training system and its responsiveness to changing skills requirements (GL 13); and
- encourage R&D and innovation and support the transfer of knowledge through FDI (GL 13).

The education reform is in its initial stages ...

In order to reform the education system the measures taken so far aim at increasing the efficiency of the system and improving its financing. However, no significant measures to enhance the quality and increase the responsiveness of the education system to market needs have been undertaken yet. The government has implemented the first stage of the reform of the primary and secondary schooling intended to decentralise, restructure and rationalise the system through changes in financing. However, a major reform including the changes in curricula is only now being prepared. Also, a major reform of tertiary education is outstanding. The Education Bill was rejected by the Parliament and will be resubmitted for discussion soon. The major change in the Bill is the introduction of tuition fees, which are expected to provide the universities with greater resources and, at the same time, exert pressure to improve the quality of education. The Slovak authorities expect that this would also induce students to choose specialisations demanded by the market.

...the progress on R&D is slow...

The progress in encouraging R&D activities has been limited so far. The government is planning a reform of R&D financing which should create a system based on excellence. Measures to encourage R&D are included in the 'National Lisbon Strategy'. The public spending on R&D is very low but the government foresees some increases in the forthcoming period.

Slovakia has attracted significant inflows of FDI which are expected to contribute to know-how and technology transfer. The major investments target the automotive industry. Technology transfer might be somewhat inhibited by the limited links between the foreign-owned companies and domestic enterprises.

...but information technologies are spreading.

The numbers of households and companies connected to the Internet are increasing quickly and, by the end of 2004, all the schools should be connected to the Internet. However, the successful development of information technologies has been hampered by the low level of competition in the telecommunication sector.

Table 22.1: Economic indicators for Slovakia

	Slovakia				EU-25			
	2001	2002	2003	2004	2001	2002	2003	2004
General economic background								
Real GDP growth ¹	3.8	4.6	4.0	4.9	1.8	1.1	1.0	2.5
Inflation ²	7.2	3.5	8.5	7.7	2.5	2.1	1.9	2.2
Labour productivity growth ³	3.2	5.2	2.2	5.0	0.8	0.9	0.9	2.1
Employment growth ¹	0.6	-0.5	1.7	-0.1	1.0	0.3	0.3	0.4
Nominal wage growth ⁴	6.3	9.3	9.9	9.9	4.0	3.2	3.1	3.0
Current account ⁵	-7.4	-8.2	-1.1	-2.9	:	:	:	:
Unemployment ⁶	19.4	18.7	17.5	18.4	8.5	8.9	9.1	9.1
Public finance								
General government balance ⁵	-6.0	-5.7	-3.7	-3.9	-1.2	-2.3	-2.8	-2.8
Primary balance ⁵	-2.0	-2.1	-1.2	-1.6	2.4	1.0	0.3	0.2
Cyclically-adjusted balance ⁵	:	:	:	:	:	:	:	:
Gross government debt ⁵	48.7	43.3	42.6	44.2	62.1	61.6	63.2	63.5
Employment								
Employment rate ⁷	56.8	56.8	57.7	:	62.8	62.9	63.0	:
Female employment rate ⁸	51.8	51.4	52.2	:	54.3	54.7	55.1	:
Employment rate for older workers ⁹	22.4	22.8	24.6	:	37.4	38.8	40.2	:
Long-term unemployment ¹⁰	11.4	12.2	11.1	:	3.8	3.9	4.0	:
Tax rate on low wage earners ¹¹	40.4	40.1	40.3	:	37.2	37.1	37.4	:
Unemployment trap indicator ¹²	81	76	73.2	:	78.8	78.5	78.3	:
Product market reforms								
Hourly labour productivity ¹³	46.1	50.0	43.7	:	:	:	:	:
Total trade to GDP ratio ¹⁴	77.8	74.3	78.1	:	:	58.8	57.2	:
Internal Market Directives ¹⁵	:	:	:	93.5	:	:	:	96.3
Business investment ¹⁶	25.7	24.3	23.2	:	17.9	17.2	16.8	:
Knowledge-based economy								
Total tertiary graduates ¹⁷	29.2	30.7	:	:	46.8	:	:	:
Spending on human resources ¹⁸	4.0	:	:	:	5.1	:	:	:
R&D expenditure ¹⁹	0.6	0.6	0.6	:	1.9	1.9	:	:
Expenditure on IT ²⁰	2.7	2.7	2.5	2.4	3.1	2.9	2.9	2.9

¹ Growth rate in percentage.

² Annual average rate of change in harmonised index of consumer prices in percentage.

³ Growth rate of real GDP per occupied person in percentage.

⁴ Growth rate of compensation per employee.

⁵ As a percentage of GDP.

⁶ Number of unemployed as a percentage of the labour force.

⁷ Employed persons aged 15-64 as a share of the total population of the same age group.

⁸ Employed women aged 15-64 as a share of the total female population of the same age group.

⁹ Employed persons aged 55-64 as a share of the total population of the same age group.

¹⁰ Long-term unemployed (over 12 months) as a percentage of the total active population aged 15-64.

¹¹ Income tax plus employer/employee contributions as a percentage of labour costs of a single earner at 67% of the Average Production Worker-wage, no children.

¹² Effective tax rate on labour income taking into account the combined effect of increased taxes and benefits withdrawal as an individual moves from unemployment back to work earning 67% of the Average Production Worker-wage, measured at the first month of unemployment (after any 'waiting period' if applicable).

¹³ GDP per hour worked in PPS, EU-15=100.

¹⁴ Percentage, average value of imports and exports of goods and services divided by GDP, multiplied by 100. For DE, ES, FR, IT, PL and the UK the value for EU-25 is the total for the large Member States, for all the other states the value for EU-25 is the total for the small Member States.

¹⁵ Percentage implemented in November 2004.

¹⁶ Gross fixed capital formation by the private sector as a percentage of GDP.

¹⁷ Total tertiary graduates (ISCED 5-6) per 1000 of population aged 20-29.

¹⁸ Public expenditure on education as a percentage of GDP.

¹⁹ GERD Gross domestic expenditure on R&D as a percentage of GDP.

²⁰ Expenditure on information technology as a percentage of GDP.

Source: Commission services (incl. Eurostat, structural indicators)

The data for 'general economic background' and 'public finance' are taken from the Commission's Autumn 2004 Economic Forecasts.

23. FINLAND

Introduction

Real GDP growth accelerated from 2.0 per cent in 2003 to an estimated 3 per cent in 2004, remaining well above the euro-area average. Activity was firmly supported by domestic demand as private consumption stayed lively while the sharp fall in business equipment investment of the last two years turned around. The revival of exports was held back by weaknesses in the electronics industry in the early part of 2004. The recovery has begun to be felt in the labour market, with employment increasing and unemployment falling. Public finances remain solid, with the general government surplus set to remain over 2 per cent of GDP in 2004-06. In 2004, the government followed up on earlier commitments, such as by adhering to the multi-annual spending limits set for the entire election period. By way of new measures, it introduced further tax cuts on labour. Despite these tax cuts, structural unemployment remains high, although the new wage agreement allows wages to better reflect productivity differences. Concerning productivity and business dynamism, Finland has maintained its leading position by being one of the most competitive economies in the world. R&D spending is high (3.4 per cent of GDP) and is two thirds financed by industry. Labour productivity per hour worked is below the EU-15 average, but is growing at a slightly faster rate than the average. The competition law has recently been updated and efforts have been made to bring competition policy into the heart of economic policy, but problems continue in some of the network industries. Moreover, prices remain high compared with the EU average.

A detailed assessment of recent developments in addressing Finland's key policy challenges is presented in the following sections.

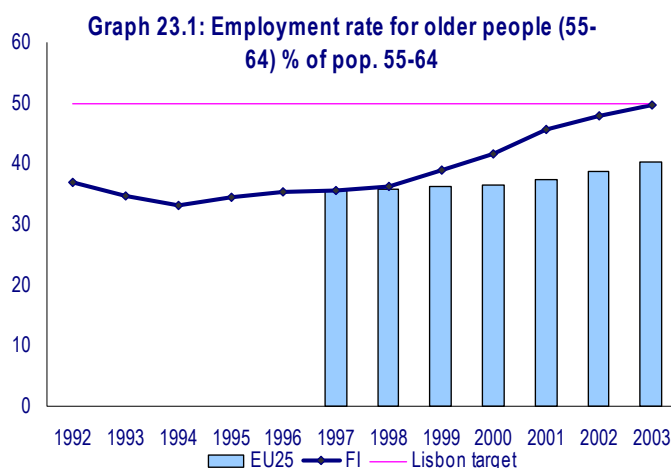
1. Labour market

Reduce the high level of structural unemployment and increase the employment rate of older workers	Assessment
Under this challenge, Finland was requested to:	
1. improve incentives in tax and benefit systems further to make work pay, in particular by addressing their combined effects on older workers, continue to reform the eligibility criteria, improve the administration of benefit systems and target the tax measures on low-paid labour (GL 4); and	In progress
2. seek possibilities to ensure that wage bargaining systems allow wages to better reflect productivity differences across skills in order to improve the job prospects of low-skilled unemployed (GL 5).	Limited
Bearing in mind the three-year period available for implementation, the degree of implementation since 2003 is indicated as: "Complete" for (practically) complete; "In progress" where progress is well advanced; "Limited" where the recommendation is only partially addressed and "Insufficient" where no substantial measures going in the right direction have been taken.	

Although Lisbon target for employment of older workers was reached, structural unemployment remains high...

In 2004, the government cut income taxes by a total of € 775 million i.e. 0.5 per cent of GDP, by lowering marginal tax rates in state income tax schedules, increasing work-related deductions and earned income deductions in municipal taxation. Combined with the tax cut worth € 295 million in 2003, this almost lives up to the minimum target of € 1.12 billion in tax cuts, i.e. 0.8 per cent of GDP over the electoral period 2003-07 set in the government

programme. However, as a comprehensive, moderate and long-term wage agreement was achieved between the social partners in late-November 2004 the government supplemented the outcome with a proposal to reduce taxation in 2005 by a further € 350 million i.e. 0.2 per cent of GDP through an increase in earned income deductions in municipal taxation and lowering the state income tax scale. In addition, the government is proposing to cut income taxes by € 1.36 billion i.e. 0.8% of GDP between 2006 and 2007. This more than doubles the government's initial plan for reducing income taxation. In the 2005 budget proposal, the tax burden on employment was reduced by extending further the tax deduction granted for household service work in order to increase the incentive for private households to employ service work. Also, the government proposed a 2 per cent inflation adjustment to the state income tax scale, reducing tax revenues by € 160 million or 0.1 per cent of GDP. Moreover, to support growth in the smallest companies, the sliding maximum limit on value added tax relief was raised to €



22 500. Furthermore, a reform of capital and corporate income taxation entered into force at the beginning of 2005. The corporate income tax rate was reduced by 3 percentage points to 26 per cent and the capital tax rate by 1 percentage point to 28 per cent, yielding an initial decline in tax receipts from business and capital taxation by € 555 million, i.e. 0.4 per cent of GDP. However, in the long run the tax reform is expected to increase tax receipts via stimulating effects on investment and growth.

In 2003, the government had introduced an intersectoral employment programme, to raise the employment rate and prevent social exclusion. The emphasis of the programme is to reduce the high level of structural unemployment and boost labour supply. Key measures to achieve these targets include reforming public employment services, raising the participation of job-seekers in active labour market policy measures (activation rate) to 30 per cent, shifting the emphasis from passive to active labour market support and improving the effectiveness of active labour market programmes. These measures have already produced some early results: 29 new labour force service centres have been opened, which provide services for the most difficult-to-place job-seekers, and the activation rate of unemployed job-seekers rose by 1 percentage point to 24 per cent in 2004. Nevertheless, the government's target of creating 100 000 new jobs by the end of the electoral term in 2007 will be difficult to meet under current growth conditions. Also, the objective of raising the employment rate to 75 per cent by 2011 appears difficult to attain. However, the momentum towards reaching these targets should be kept up in view of the serious challenges Finland will be facing as a consequence of population ageing over the next decade.

On the positive side, the employment rate of older workers has been rising markedly over the last few years and this development is expected to continue when the 2002 pension reform is implemented in 2005. According to data on the first half of 2004, the Lisbon target of 50 per cent employment rate for older workers has already been achieved. Concerning the tightening of the eligibility criteria, there has been some progress, relating to measures already implemented in 2003 in the context of pension reform, such as raising the minimum age of eligibility for part-time pension by two years. Improvement of the administration of benefit systems is linked to the founding of labour force service centres. These centres operate on the one-stop-shop principle, making the services of different authorities such as

the employment office, the municipality and the Social Insurance Institution available at the same location, thereby increasing the effectiveness of the administration benefit systems. Progress in improving incentives in benefit systems has been made with the aim of dismantling income traps as the Act on unemployment benefit was amended from the beginning of 2004 to alleviate means tests for labour market support with regard to spouses' income. Moreover, the government is looking into ways to improve work incentives for people with disabilities. Thus, it will be considered to introduce long-term or even permanent employment subsidies for employers who employ a disabled jobseeker, tailored to the reduction in the work ability of the individual employee.

The new wage agreement allows wages to better reflect productivity differences

Traditionally in the collective wage agreements, pay rises have been based on average increases in productivity across sectors, implying that low productivity sectors received higher wage rises than warranted by their productivity growth. The previous collective wage agreement that was settled in December 2002 paid more heed to this problem, and the cost effect of the pay rises was somewhat less biased against the low-wage sectors than previously. The new two-and-half-year collective wage agreement, settled on 29.11.2004, will bring further progress in this regard. The first 15 months of the wage contract is more of traditional wage agreement, where pay rises are mainly based on a fixed predetermined euro amount per month, while during latter part of the contract starting from June 2006, the wage increases are based on percentage increases across the board. This, combined with a new emphasis on local bargaining, will introduce greater flexibility to wage formation, albeit to a limited extent.

2. Productivity and business dynamism

Enhance competition in certain sectors and improve the efficiency of the public sector	Assessment
Under this challenge, Finland was requested to:	
3. set up efforts to enforce competition in network industries and non-tradable services (GL 9);	Limited
4. make further efforts to increase the efficiency of the public sector, inter alia by improving the framework conditions for increased competition, promoting the benchmarking of public sector efficiency and by increasing public tendering (GL 11); and	In progress
5. improve mechanisms to help control spending and ensuring compliance with rules on expenditure (GL 14).	In progress

Some progress towards improving the competitive environment...

In May 2004 the Finnish Parliament passed the Act on Competition Restrictions, which harmonises the Finnish competition law with the modernised EU competition law. The Finnish Competition Authority (FCA) has also been given powers to offer leniency in cartel cases, which will enhance its ability to uncover and prosecute illegal agreements. The budget of the FCA is to be increased in 2005. The Competition Institute was set up in 2004 to carry out research into competition and to educate businesses and consumers about the benefits of competition. In the telecommunications sector, barriers to entry will be reduced by the EC directive on the regulation of access to communications networks, currently being implemented into Finnish legislation, and a recent judgement by the Supreme Administrative court relating to mobile telephone call termination charges may result in lower prices. No progress appears to have been made regarding the government's concerns about excessive

market concentration in the electricity sector; the reforms suggested by a working group of Nordic competition authorities in 2003 have not yet been acted upon.

...but high prices and a lack of competition persists in some sectors of the economy

Prices in Finland are some of the highest in the EU. An investigation of price levels in different sectors of the economy by the Finnish Ministry of Finance found that prices in some sectors were up to 70 per cent higher than the EU average. Prices for consumer expenditure were particularly high. Prices in the housing sector demand further investigation in particular, due to their high level (30 per cent higher than the EU-15 average) and the fact that they account for a significant share of consumer spending (26 per cent). These results should not be considered definitive as a more in-depth analysis has yet to be completed. It has been suggested that the problem may be due in part to zoning restrictions at the local level and national standards. The government is aware of problems with zoning restrictions and there are plans to examine national standards which, the government believes raise costs and impede competitive imports.

Efforts to improve the efficiency of public services are continuing...

The government is implementing the action plan that was launched in 2003 to improve the efficiency of the public sector both at the national and municipal levels. At the national level this involves greater use of IT and the exploitation of scale efficiencies in accounting and personnel administration by moving to a service centre based approach rather than individual ministries carrying out these functions. The government has estimated that this change will lead to a 40 per cent increase in productivity when the new centres become operational in 2006. At the municipal level efforts have been made to remove disincentives and introduce productivity incentives into the financing system for municipalities, although success here has been limited so far. The government also plans to introduce efficiency conditions into the discretionary grants that it makes to municipalities.

The government is continuing to implement strategies designed to increase the efficiency of the public procurement process. In 2004 an advisory board was founded jointly by central government and the association of local municipalities to increase understanding and expand the use of public procurement. Legislative reform aimed at improving competition in public procurement, particularly in cases that fall below the EU threshold value, is currently being drafted.

...and mechanisms to help control public spending are being implemented

The basic service programme that was set up between the central government and municipalities in 2003 to improve the balance and predictability of municipalities' responsibilities, obligations and financing came into force in 2004. According to the government, early results of the programme have been encouraging. The government believes that in education and healthcare, areas both administered at the municipal level, the scope for increased productivity is between 10 per cent and 20 per cent. As mentioned above, the government has attempted to inject productivity incentives into local government financing. One example is that budget under-spends may be kept by municipalities and the money carried forward to the next year's budget.

Multi-annual spending limits have helped to keep central government expenditure under control

As reviewed in the previous implementation report, the government after taking office in June 2003 redesigned spending ceilings and made them politically binding. Under the new type of ceilings, about $\frac{3}{4}$ of budget appropriations are designed to fall within the spending limits. Excluded from the ceilings are expenditures like housing subsidies and

unemployment benefits, which typically function as automatic stabilisers. Furthermore, interest expenditures and financial investment expenditures are excluded, as well as compensation for tax losses to other levels of government due to tax reforms. A further change to the previous spending limits is that supplementary budgets are included in the ceilings. Under its new budget rules the government has also introduced, as a safety margin, a central government deficit ceiling of 2.75 per cent of GDP in national account terms, even in times of weak economic activity. The government has committed itself to take expenditure-reducing measures and other remedial action if the deficit limit on central government finances threatens to be breached.

The spending ceiling worked well in its first year in operation, namely 2004, when final expenditure remained below the spending limit by € 84 million or 0.1 per cent of GDP. Also, the 2005 budget proposal is within the ceiling, with expenditures of € 377 million or 0.2 per cent of GDP below the ceiling. This leeway will be used to cover any supplementary budgets and pay rises following from the new wage agreement.

Table 23.1: Economic indicators for Finland

	Finland				EU-25			
	2001	2002	2003	2004	2001	2002	2003	2004
General economic background								
Real GDP growth ¹	1.1	2.3	2.0	3.0	1.8	1.1	1.0	2.5
Inflation ²	2.7	2.0	1.3	0.2	2.5	2.1	1.9	2.2
Labour productivity growth ³	-0.4	1.3	1.9	3.5	0.8	0.9	0.9	2.1
Employment growth ¹	1.5	0.9	0.0	-0.4	1.0	0.3	0.3	0.4
Nominal wage growth ⁴	4.7	1.9	3.3	4.1	4.0	3.2	3.1	3.0
Current account ⁵	6.9	7.4	5.2	4.9	:	:	:	:
Unemployment ⁶	9.1	9.1	9.0	8.8	8.5	8.9	9.1	9.1
Public finance								
General government balance ⁵	5.2	4.3	2.3	2.3	-1.2	-2.3	-2.8	-2.8
Primary balance ⁵	7.9	6.5	4.1	4.1	2.4	1.0	0.3	0.2
Cyclically-adjusted balance ⁵	4.5	4.1	2.8	2.8	:	:	:	:
Gross government debt ⁵	43.8	42.6	45.6	44.8	62.1	61.6	63.2	63.5
Employment								
Employment rate ⁷	68.1	68.1	67.7	:	62.8	62.9	63.0	:
Female employment rate ⁸	65.4	66.2	65.7	:	54.3	54.7	55.1	:
Employment rate for older workers ⁹	45.7	47.8	49.6	:	37.4	38.8	40.2	:
Long-term unemployment ¹⁰	2.5	2.3	2.3	:	3.8	3.9	4.0	:
Tax rate on low wage earners ¹¹	41.0	40.2	39.5	:	37.2	37.1	37.4	:
Unemployment trap indicator ¹²	80.6	83.4	81.5	:	78.8	78.5	78.3	:
Product market reforms								
Hourly labour productivity ¹³	95.5	93.0	91.5	:	:	:	:	:
Total trade to GDP ratio ¹⁴	35.9	34.6	34.4	:	:	58.8	57.2	:
Internal Market Directives ¹⁵	99.3	99.4	98.6	97.5	:	:	:	96.3
Business investment ¹⁶	17.7	16.1	15.3	:	17.9	17.2	16.8	:
Knowledge-based economy								
Total tertiary graduates ¹⁷	58.3	:	:	:	46.8	:	:	:
Spending on human resources ¹⁸	6.2	6.4	:	:	5.1	:	:	:
R&D expenditure ¹⁹	3.4	3.5	3.4	:	1.9	1.9	:	:
Expenditure on IT ²⁰	3.5	3.4	3.4	3.4	3.1	2.9	2.9	2.9

¹ Growth rate in percentage.

² Annual average rate of change in harmonised index of consumer prices in percentage.

³ Growth rate of real GDP per occupied person in percentage.

⁴ Growth rate of compensation per employee.

⁵ As a percentage of GDP.

⁶ Number of unemployed as a percentage of the labour force.

⁷ Employed persons aged 15-64 as a share of the total population of the same age group.

⁸ Employed women aged 15-64 as a share of the total female population of the same age group.

⁹ Employed persons aged 55-64 as a share of the total population of the same age group.

¹⁰ Long-term unemployed (over 12 months) as a percentage of the total active population aged 15-64.

¹¹ Income tax plus employer/employee contributions as a percentage of labour costs of a single earner at 67% of the Average Production Worker-wage, no children.

¹² Effective tax rate on labour income taking into account the combined effect of increased taxes and benefits withdrawal as an individual moves from unemployment back to work earning 67% of the Average Production Worker-wage, measured at the first month of unemployment (after any 'waiting period' if applicable).

¹³ GDP per hour worked in PPS, EU-15=100.

¹⁴ Percentage, average value of imports and exports of goods and services divided by GDP, multiplied by 100. For DE, ES, FR, IT, PL and the UK the value for EU-25 is the total for the large Member States, for all the other states the value for EU-25 is the total for the small Member States.

¹⁵ Percentage implemented in November 2004.

¹⁶ Gross fixed capital formation by the private sector as a percentage of GDP.

¹⁷ Total tertiary graduates (ISCED 5-6) per 1000 of population aged 20-29.

¹⁸ Public expenditure on education as a percentage of GDP.

¹⁹ GERD Gross domestic expenditure on R&D as a percentage of GDP.

²⁰ Expenditure on information technology as a percentage of GDP.

Source: Commission services (incl. Eurostat, structural indicators)

The data for 'general economic background' and 'public finance' are taken from the Commission's Autumn 2004 Economic Forecasts.

24. SWEDEN

Introduction

Swedish economic growth was strong in 2004 and is forecast to remain above potential rates also in the medium term. In 2004, net exports in particular, private consumption and investment expansion contributed to the growth performance. In the coming years domestic demand will be the main driver. Wage developments have been contained and inflationary pressures low. In response to weak labour market developments, the government in 2004 implemented measures to strengthen employment and to reduce unemployment. With the income tax cuts introduced in the Budget for 2005, the government has nearly completed its income tax reform. However, incentives to work, contributing to higher labour force participation and a better labour market performance, remain to be strengthened. The fiscal policy framework and plans, focusing on sound public finances, suggest the continuation of a sound budgetary position. The hourly productivity trend growth in 1999-2003 was above the EU15 average. The ICT sector and increased use of ICT in the production of other goods and services contributed to this strong productivity growth. However, weak competition in several sectors of the economy and inefficiencies in the public sector were still limiting factors, and the price level remains one of the highest in the EU. A detailed assessment of recent developments in addressing Sweden's key policy challenges is presented in the following sections.

1. Labour market

Ensure an adequate labour supply in view of the ageing of the population	Assessment
Under this challenge, Sweden was requested to:	
1. pursue further the reforms of tax and benefit systems to improve work incentives, in particular for those groups with high marginal effective taxes (GL 4), and complete the tax reform on labour income while maintaining sound public finances.	Limited
Bearing in mind the three-year period available for implementation, the degree of implementation since 2003 is indicated as: "Complete" for (practically) complete; "In progress" where progress is well advanced; "Limited" where the recommendation is only partially addressed and "Insufficient" where no substantial measures going in the right direction have been taken.	

Employment rates remain very high, though falling also in 2004

Employment rates, while remaining very high and well beyond the Lisbon targets, fell further in 2004 in spite of very strong economic activity, reflecting in part a normal phase of a lagged labour market response to the cycle. The Swedish authorities implemented measures in 2004 to reduce unemployment through an expansion of places in labour market programmes. Additional financial support to local government also contributed. However, some initiatives may have an adverse impact on labour supply. Since the review in the 2004 Implementation Report, the extension throughout the country of the 'free-year' initiative (under which an employee can, while paid a salary-linked benefit, take up to one year off work under certain conditions) has been confirmed and will take effect in 2005. On the tax side, there has been some further easing of labour taxation in the framework of the 'green tax swap' strategy. With the Budget Bill for 2005, the Swedish government has made further progress in implementing its income tax reform, with half of the fourth and final step of tax cuts taking effect in 2005 (the first three steps were taken in 2000-02). However, these tax cuts mainly consist of a higher basic allowance and therefore have limited impact on marginal tax rates and thus work incentives. Moreover, local government tax rates were increased further in 2004. According to the Swedish government, the intention is to finalise the income tax reform in 2006 should the budgetary position allow it. On the benefit side, a

mixed picture emerges. On the one hand the authorities announced plans in the 2005 Budget to raise certain social insurance benefit levels. Moreover, the cut in the sickness insurance benefit level introduced in 2003 was reversed as from 1 January 2005. On the other hand, in order to achieve the nationally set target of halving the number of sick days by 2008 (compared with 2002), additional measures, including enforcement of the rules for receiving sickness insurance, were implemented in 2004. All in all, further efforts to increase labour market participation and employment appear important; not least as according to the Budget for 2005 the Swedish authorities do not expect to have reached their nationally set target of raising employment by 2004. Despite downward revisions of the budgetary targets in the latest Budget, broadly consistent with the Commission services' autumn 2004 forecast, Sweden is expected to continue to show a sound fiscal position in coming years⁹.

2. Productivity and business dynamism

Enhance competition in certain sectors and improve the efficiency of the public sector.	Assessment
Under this challenge, Sweden was requested to:	
2. step up efforts to enforce competition in sectors where competition is inadequate (GL 9); and	Limited
3. make further efforts to increase the efficiency of the public sector, <i>inter alia</i> by improving framework conditions for increased competition, promoting the benchmarking of public-sector efficiency, and by increasing public tendering (GL 11).	Limited

Some steps towards increased competition taken...

Prices in Sweden remain among the highest in the EU, with very high prices in sectors such as retailing, construction, housing, and non-tradable sectors, and so far there are few signs of increased competition. In September 2004 the Government started an investigation in order to improve the implementation of competition policy. In October 2004, a law intended to increase price transparency for all goods and services marketed to consumers took effect. At the sectoral level, the application of the planning and building legislation may constitute an obstacle to competition in the construction and food retailing sector. A commission has therefore been appointed by the government to review the legislation and analyse how competition aspects can be better taken into account in the actual planning process, and thereby provide better conditions for increased competition within these sectors. Some suspected cartels in the construction sector are currently being investigated by the competition authorities. A project to increase competition and trade in the construction sector involving the Nordic and Baltic countries and Poland is also still underway. However, no further measures have been taken in order to open up the non-tradable sectors.

...and further efforts to increase public sector efficiency have been made.

There is still little evidence of increased efficiency in the public sector. However the Swedish government has acknowledged the importance of reviewing and improving the

⁹ Eurostat's decision of 2 March 2004 on the classification of pension schemes, to be implemented by March 2007 at the latest according to their press release of deficit and debt data for 2003 of 23 September, would in all likelihood reduce the general government balance in Sweden by about 1 per cent of GDP per annum.

functioning of the public sector. No later than February 2005, a commission will present proposals on how the new EC directives on public procurement should be implemented in Swedish law. In September 2005, a report to be presented by Council for Municipal Analysis on the development of key national indicators could contribute to the benchmarking of public sector efficiency.

Table 24.1: Economic indicators for Sweden

	Sweden				EU-25			
	2001	2002	2003	2004	2001	2002	2003	2004
General economic background								
Real GDP growth ¹	0.9	2.1	1.6	3.7	1.8	1.1	1.0	2.5
Inflation ²	2.7	2.0	2.3	1.1	2.5	2.1	1.9	2.2
Labour productivity growth ³	-1.0	1.9	1.8	4.3	0.8	0.9	0.9	2.1
Employment growth ¹	1.9	0.2	-0.2	-0.5	1.0	0.3	0.3	0.4
Nominal wage growth ⁴	4.5	2.7	2.4	3.4	4.0	3.2	3.1	3.0
Current account ⁵	4.4	5.1	5.7	7.3	:	:	:	:
Unemployment ⁶	4.9	4.9	5.6	6.3	8.5	8.9	9.1	9.1
Public finance								
General government balance ⁵	2.8	0.0	0.3	0.6	-1.2	-2.3	-2.8	-2.8
Primary balance ⁵	6.0	2.9	2.3	2.7	2.4	1.0	0.3	0.2
Cyclically-adjusted balance ⁵	3.1	0.6	1.4	0.7	:	:	:	:
Gross government debt ⁵	54.4	52.6	52.0	51.6	62.1	61.6	63.2	63.5
Employment								
Employment rate ⁷	74	73.6	72.9	:	62.8	62.9	63.0	:
Female employment rate ⁸	72.3	72.2	71.5	:	54.3	54.7	55.1	:
Employment rate for older workers ⁹	66.7	68.0	68.6	:	37.4	38.8	40.2	:
Long-term unemployment ¹⁰	1.0	1.0	1.0	:	3.8	3.9	4.0	:
Tax rate on low wage earners ¹¹	46.8	45.8	44.8	:	37.2	37.1	37.4	:
Unemployment trap indicator ¹²	87.3	87.1	87.1	:	78.8	78.5	78.3	:
Product market reforms								
Hourly labour productivity ¹³	95.2	95.3	97.4	:	:	:	:	:
Total trade to GDP ratio ¹⁴	42.6	41.3	40.5	:	:	58.8	57.2	:
Internal Market Directives ¹⁵	99.1	99.6	98.4	97.9	:	:	:	96.3
Business investment ¹⁶	14.4	13.4	12.6	12.5	17.9	17.2	16.8	:
Knowledge-based economy								
Total tertiary graduates ¹⁷	38.5	41.5	:	:	46.8	:	:	:
Spending on human resources ¹⁸	7.3	7.7	:	:	5.1	:	:	:
R&D expenditure ¹⁹	4.3	:	:	:	1.9	1.9	:	:
Expenditure on IT ²⁰	4.7	4.3	4.0	3.9	3.1	2.9	2.9	2.9

¹ Growth rate in percentage.

² Annual average rate of change in harmonised index of consumer prices in percentage.

³ Growth rate of real GDP per occupied person in percentage.

⁴ Growth rate of compensation per employee.

⁵ As a percentage of GDP.

⁶ Number of unemployed as a percentage of the labour force.

⁷ Employed persons aged 15-64 as a share of the total population of the same age group.

⁸ Employed women aged 15-64 as a share of the total female population of the same age group.

⁹ Employed persons aged 55-64 as a share of the total population of the same age group.

¹⁰ Long-term unemployed (over 12 months) as a percentage of the total active population aged 15-64.

¹¹ Income tax plus employer/employee contributions as a percentage of labour costs of a single earner at 67% of the Average Production Worker-wage, no children.

¹² Effective tax rate on labour income taking into account the combined effect of increased taxes and benefits withdrawal as an individual moves from unemployment back to work earning 67% of the Average Production Worker-wage, measured at the first month of unemployment (after any 'waiting period' if applicable).

¹³ GDP per hour worked in PPS, EU-15=100.

¹⁴ Percentage, average value of imports and exports of goods and services divided by GDP, multiplied by 100. For DE, ES, FR, IT, PL and the UK the value for EU-25 is the total for the large Member States, for all the other states the value for EU-25 is the total for the small Member States.

¹⁵ Percentage implemented in November 2004.

¹⁶ Gross fixed capital formation by the private sector as a percentage of GDP.

¹⁷ Total tertiary graduates (ISCED 5-6) per 1000 of population aged 20-29.

¹⁸ Public expenditure on education as a percentage of GDP.

¹⁹ GERD Gross domestic expenditure on R&D as a percentage of GDP.

²⁰ Expenditure on information technology as a percentage of GDP.

Source: Commission services (incl. Eurostat, structural indicators)

The data for 'general economic background' and 'public finance' are taken from the Commission's Autumn 2004 Economic Forecasts.

25. UNITED KINGDOM

Introduction

Recent economic performance in the UK has been strong by international standards. Output growth in 2004 is estimated to have been relatively robust, well above Commission estimates of the trend rate of growth, though some moderation is expected for the years ahead as household and general government consumption growth softens. Labour market performance is good: unemployment is at near-record lows, remaining below 5 per cent in 2004, while employment rates are amongst the highest in the EU. Despite the strength of economic performance, and the apparent tightness of the labour market, inflationary pressures generally remain subdued, with HICP inflation well below the Bank of England's new 2 per cent inflation target set in December 2003. Notwithstanding this sound performance, the UK faces several challenges. Increasing the UK's level of productivity is a key objective. The UK has been making progress on boosting hourly labour productivity growth, and the gap in productivity levels relative to the EU15 average has been closing over a number of years. The government's approach to raising productivity has centred on maintaining macroeconomic stability and implementing microeconomic reforms to remove hindrances to efficiently functioning markets. Reforms have focused on taking measures to improve competition, enterprise, innovation, skills, investment and public services' productivity, with varying degrees of progress, but more needs to be done to close the productivity gap with the EU-15 average. The government projects an improvement in the public finances over the medium-term, though evidence of significant progress has yet to be confirmed in outturn data. A detailed assessment of recent developments in addressing the United Kingdom's key policy challenges is presented in the following sections.

1. Productivity

Improve the relatively low level of productivity	Assessment
Under this challenge, the United Kingdom was requested to:	
1. continue to improve competition in sectors like the professions, postal services and pharmacies (GL 9);	Limited
2. monitor closely existing measures to promote R&D (GL 13); and	Limited
3. review and strengthen, where appropriate, policies aimed at improving basic skills in the work force (GL 13).	In progress
Bearing in mind the three-year period available for implementation, the degree of implementation since 2003 is indicated as: "Complete" for (practically) complete; "In progress" where progress is well advanced; "Limited" where the recommendation is only partially addressed and "Insufficient" where no substantial measures going in the right direction have been taken.	

Some progress in improving competition in protected sectors.

The government has set a target to have a competition regime that is among the best in the world by 2006. Evidence that this target is achievable is provided by a number of studies giving a positive assessment of the current regime. The government has continued its efforts to promote competition but progress has varied across sectors. Since 2003, a number of restrictions on competition in professions such as accountancy have been removed but others still need to be addressed. The government has consulted on and subsequently commissioned an independent review of proposals to reform the regulatory framework for legal services in England and Wales to improve competition in this sector. Recommendations of the review are expected shortly.

More limited progress has been made on improving competition in pharmacies and postal services. The government rejected an Office of Fair Trading (OFT) proposal to remove many of the restrictions on entry in the pharmacy sector as it considered that this conflicted with its objectives for increasing the role of pharmacies within the National Health Service. In postal services, about 30 per cent of the total letters market has been open to competition for bulk mail services since 2003. However, in practice it has been difficult to achieve a significant amount of competition and the state-owned monopoly, Royal Mail, retains more than 99 per cent of the entire market. The postal regulator has, meanwhile, continued efforts to further liberalise postal services, and is proposing to bring forward full liberalisation, abolishing all restrictions on market entry, to January 2006.

Finally, the OFT has investigated the effect on competition of public sector procurement (which accounts for between 11 to 18 per cent of UK GDP). The results of a study were published in September 2004, and identified a number of sectors for further investigation.

Limited monitoring and evaluation of the measures taken to promote R&D.

The UK has made a number of efforts to promote R&D. Although records are kept of public and private sector spending on R&D, and the Department for Trade and Industry has a mechanism for evaluating a very small number of R&D initiatives, there has so far been little overall evaluation of the success of government R&D policy and, in particular, measures to boost both public and private R&D and innovation. The government's strategy to promote R&D and innovation emphasises the need for conducive macroeconomic, fiscal, competition and trade policies, and improving education and skills. The government has also been using a wide range of other measures to boost R&D expenditure and innovation, such as the use of R&D tax credits and project-specific grants. The government launched a Science and Innovation Investment Framework in July 2004, setting out the UK's target for R&D expenditure to reach 2.5% of GDP by 2014 as well as the policy framework needed to achieve this. The framework sets out a comprehensive set of targets and performance indicators to track progress. The 2004 Pre-Budget Report announced further steps to support implementation and monitoring of the framework, including a biennial assessment of progress against target, and a commitment to publish a detailed sectoral assessment of UK business R&D alongside the 2005 Budget. Other steps announced include the establishment of a business-led strategy board, which will advise the government on technologies which have commercial potential, and a regular high level forum of key government ministers, business leaders and scientists.

Ongoing initiatives to boost training and basic skills

The UK authorities consider improving skills among young people and the adult workforce to be one of the key drivers of improved productivity performance. In direct response to low productivity levels, the April 2003 Budget included a number of measures to boost training and basic skills. The March 2004 Budget and the December 2004 Pre-Budget Report build on these. Following successful pilot schemes, the government has announced the full implementation (by 2007/08) of a subsidised workforce-level training scheme to provide all employed people in England the opportunity to secure Level 2 skills training, such skills being considered as the foundation for employability and lifelong learning. The target for numbers involved in programmes to raise basic literacy, ICT and numeracy skills has been extended from 1.5 million adults by 2007 to 2.25 million adults by 2010. The government has reformed and re-launched apprenticeship schemes, including young apprenticeships for 14-16 year olds, and is introducing trials of apprenticeship programmes for adults. Long-term reform of the qualifications and curriculum for 14-19 year-olds is also under review, with a policy response expected in 2005.

Although a number of these measures take the form of pilot schemes, the authorities report that since 2001 over 2.3 million adults have started basic skills courses, and almost 750,000 adults have achieved literacy, numeracy and ICT qualifications. Further, while 29% of adults in the workforce lack Level 2 skills, the number without a Level 2 qualification has fallen by 434,000. This should help the authorities achieve their stated aim of decreasing, by 40 per cent by 2010, the number of adults in the workforce who do not have a Level 2 qualification.

The government's initiatives are set in a medium-to-long term perspective based on July 2003 proposals to develop workforce skills. While the initiatives to strengthen apprenticeships and facilitate adult learning represent welcome steps, it appears too early to judge whether the many different initiatives will work together, as a set, to raise productivity by boosting basic skills.

2. Labour market

Address the high numbers of working-age people claiming sickness and disability benefits and sustain labour supply in the longer term	Assessment
Under this challenge, the United Kingdom was requested to:	
4. ensure that all those who are able to work have the opportunities and incentives to do so, in particular by examining and reforming as necessary sickness and disability benefit schemes (GL 4).	In progress

New initiatives for sickness and disability benefit claimants

While unemployment has fallen to around 4.7 per cent, the number of people claiming incapacity and severe disability benefits was 2.7 million (roughly 7 per cent of the workforce) in May 2004. There are strong regional and local variations in the scale of the problem. Importantly, however, there are signs that growth in the number of claimants has slowed in recent years, with the total number of working-age claimants stabilising over the last year or so.

Operation began in October 2003 of the 'Pathways to Work' pilot schemes, the purpose of which was to test an intervention regime aimed at actively supporting incapacity benefit claimants' return to work. In its March 2004 budget, the government announced it would extend provision in the existing pilot areas. The December Pre-Budget Report announced a major expansion of these pilots to cover 900,000 incapacity benefits claimants in areas with the highest concentrations of claimants.

The authorities will also pilot a scheme for a mandatory work-focused interview regime for some existing incapacity benefit claimants and a new job preparation premium for people pursuing an activity that supports their return to work. The latter will be piloted from February 2005. The Pre-Budget Report also announced an additional pilot scheme that will place employment advisers in doctors' surgeries, and, to ease the transition into employment, simplified rules on the work claimants are allowed to undertake while still claiming benefits.

3. Quality and efficiency of public services

Improve the quality and efficiency of public services	Assessment
Under this challenge, the United Kingdom was requested to:	
5. ensure that the public services associated with the announced increases in public expenditure (including investment in the transport infrastructure) are delivered efficiently and with a view to ensuring cost-effectiveness (GL 11 and 14).	In progress

A new strategy for increasing public sector efficiency

Recent years have witnessed a large increase in expenditure on public services in the UK, aimed at addressing a perceived legacy of under-investment and under-provision. The authorities have recognised the need of efforts to ensure the efficiency of public spending, which will become increasingly important as the rate of growth in total expenditure is expected to slow, if efforts to improve public services are to be maintained at the current pace.

The key development in 2004 was the publication of a major review of public sector efficiency. Building on this, government departments have submitted plans to achieve significant annual efficiency savings that are expected to reach £21.5 billion (roughly 0.2 per cent of GDP) over the medium term (by 2007-08). Key points include:

- a reduction in administrative costs of at least 5 per cent in real terms over the period 2006/07 – 2007/08 for each department; and
- a net reduction in civil-service employment of 70,600 posts (roughly 13.5 per cent relative to an April 2004 complement of 524,580) in central government by 2008.

In order to ensure the successful implementation of the drive for greater efficiency, a formal process of assessing departmental progress is being implemented. Government departments will be required to report publicly on progress against targets, while reports setting out how performance will be measured have been scrutinised by the National Audit Office (NAO) and the Audit Commission. In addition, all departments will be required to have, by December 2006, a professional finance director reporting to the Head of Department (the Permanent Secretary), with a seat on the departmental board.

This “input-oriented” approach should complement the existing focus on outputs/results underpinned by Public Service Agreements (PSAs): target outcomes, agreed as part of each department’s budget. Assessing the ultimate success of the initiative will, however, require longer-term analysis, not least because some of the potential savings identified are difficult to assess *ex ante*. In addition, transparency will be key to ensuring a successful outcome that is easily demonstrable to the wider public – indicating a premium on ensuring that the departmental reviews of measurement and assessment are clear, rigorous and accessible.

In parallel, significant efforts are being made to improve the measurement of public sector output, with an interim independent review of these issues having been published in July 2004, and a final report due in January 2005. More accurate measurement would complement the broader efforts to improve efficiency; in this regard, improved measures of health sector output have already been adopted.

4. Public finances

Strengthen the budgetary position so as to avoid emerging budgetary imbalances	Assessment
Under this challenge, the United Kingdom was requested to:	
6. in endeavouring to avoid the occurrence of an excessive deficit, to improve the cyclically-adjusted position to consolidate the public finances, consistent with a budgetary position of close to balance or in surplus in the medium term (GL 1).	Limited

Signs of budgetary improvement, but uncertainties exist

The UK's general government deficit is now estimated to have reached 3.4 per cent of GDP in 2003, and is estimated to have been 3.2 per cent of GDP for financial year 2003/04¹⁰. A Commission report of April 2004¹¹ assessed UK budgetary developments. After considering the report, the Economic and Financial Committee (EFC) concluded that an excessive deficit, in the sense of the Treaty, did not exist and therefore that the UK's budgetary position did not warrant further steps under the excessive deficit procedure¹².

The government did not adopt any specific measures in 2004 to improve the budgetary position, though the authorities' March projections foresaw an improvement in the general government deficit on the basis of existing policy measures. This was also the view taken in the Commission services' autumn 2004 forecast, where the deficit is expected to narrow and be under 3 per cent of GDP for each calendar year of the 2004-06 forecast period. A clear improvement is also foreseen in cyclically-adjusted terms, and with growth in general government consumption projected to slow relative to 2004, and revenues to recover relative to nominal income. Revenues should increase as a result of strong GDP growth, albeit at a slower pace than was forecast by the authorities in the March 2004 Budget. However, evidence of significant progress has yet to be confirmed in outturn data and there remains a high degree of uncertainty over both revenues and expenditures. In particular, it will be important to ensure that government departments adjust to the period of tighter budgets and slowing expenditure, if budgetary consolidation is to be fully implemented.

Even if the deficit improves in line with forecasts - and the risk of a worse outcome cannot be excluded - the budgetary position would remain some way from being close to balance in the medium term, with insufficient margin against future deficits in excess of 3 per cent of GDP. Nonetheless, the ratio of gross debt to GDP, though increasing slightly, is expected to remain close to 40 per cent and remain amongst the lowest in the EU.

¹⁰ Commission services' estimate, based on public finance data released 20 October 2004.

¹¹ http://europa.eu.int/comm/economy_finance/about/activities/sgp/country/edp/edprep2004_uk.pdf

¹² According to the relevant Treaty protocol, UK deficits are assessed on a financial year basis.

Table 25.1: Economic indicators for the United Kingdom

	United Kingdom				EU-25			
	2001	2002	2003	2004	2001	2002	2003	2004
General economic background								
Real GDP growth ¹	2.3	1.8	2.2	3.3	1.8	1.1	1.0	2.5
Inflation ²	1.2	1.3	1.4	1.4	2.5	2.1	1.9	2.2
Labour productivity growth ³	1.6	1.6	1.3	2.6	0.8	0.9	0.9	2.1
Employment growth ¹	0.7	0.2	0.9	0.7	1.0	0.3	0.3	0.4
Nominal wage growth ⁴	5.4	4.5	4.1	5.2	4.0	3.2	3.1	3.0
Current account ⁵	-2.3	-1.7	-1.9	-2.0	:	:	:	:
Unemployment ⁶	5.0	5.1	5.0	4.9	8.5	8.9	9.1	9.1
Public finance								
General government balance ⁵	0.7	-1.7	-3.3	-2.8	-1.2	-2.3	-2.8	-2.8
Primary balance ⁵	3.0	0.3	-1.3	-0.9	2.4	1.0	0.3	0.2
Cyclically-adjusted balance ⁵	0.3	-1.7	-2.9	-2.7	:	:	:	:
Gross government debt ⁵	38.8	38.3	39.8	40.4	62.1	61.6	63.2	63.5
Employment								
Employment rate ⁷	71.7	71.7	71.8	:	62.8	62.9	63.0	:
Female employment rate ⁸	65	65.3	65.3	:	54.3	54.7	55.1	:
Employment rate for older workers ⁹	52.3	53.5	55.5	:	37.4	38.8	40.2	:
Long-term unemployment ¹⁰	1.3	1.1	1.1	:	3.8	3.9	4.0	:
Tax rate on low wage earners ¹¹	24.5	24.5	26.2	:	37.2	37.1	37.4	:
Unemployment trap indicator ¹²	70.4	70.3	70.8	:	78.8	78.5	78.3	:
Product market reforms								
Hourly labour productivity ¹³	91.9	93.5	94.3	:	:	:	:	:
Total trade to GDP ratio ¹⁴	28.8	27.7	26.7	:	30.1	29.2	28.7	:
Internal Market Directives ¹⁵	97.6	97.4	98.6	97.5	:	:	:	96.3
Business investment ¹⁶	15.2	15.0	14.6	:	17.9	17.2	16.8	:
Knowledge-based economy								
Total tertiary graduates ¹⁷	71.4	72.7	:	:	46.8	:	:	:
Spending on human resources ¹⁸	4.7	:	:	:	5.1	:	:	:
R&D expenditure ¹⁹	1.9	1.9	:	:	1.9	1.9	:	:
Expenditure on IT ²⁰	4.0	3.8	4.4	4.0	3.1	2.9	2.9	2.9

¹ Growth rate in percentage.

² Annual average rate of change in harmonised index of consumer prices in percentage.

³ Growth rate of real GDP per occupied person in percentage.

⁴ Growth rate of compensation per employee.

⁵ As a percentage of GDP.

⁶ Number of unemployed as a percentage of the labour force.

⁷ Employed persons aged 15-64 as a share of the total population of the same age group.

⁸ Employed women aged 15-64 as a share of the total female population of the same age group.

⁹ Employed persons aged 55-64 as a share of the total population of the same age group.

¹⁰ Long-term unemployed (over 12 months) as a percentage of the total active population aged 15-64.

¹¹ Income tax plus employer/employee contributions as a percentage of labour costs of a single earner at 67% of the Average Production Worker-wage, no children.

¹² Effective tax rate on labour income taking into account the combined effect of increased taxes and benefits withdrawal as an individual moves from unemployment back to work earning 67% of the Average Production Worker-wage, measured at the first month of unemployment (after any 'waiting period' if applicable).

¹³ GDP per hour worked in PPS, EU-15=100.

¹⁴ Percentage, average value of imports and exports of goods and services divided by GDP, multiplied by 100. For DE, ES, FR, IT, PL and the UK the value for EU-25 is the total for the large Member States, for all the other states the value for EU-25 is the total for the small Member States.

¹⁵ Percentage implemented in November 2004.

¹⁶ Gross fixed capital formation by the private sector as a percentage of GDP.

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Source: Commission services (incl. Eurostat, structural indicators)

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