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**COMMISSION RECOMMENDATION**

**for the 2002 Broad Guidelines of the Economic Policies  
of the Member States and the Community**

drawn up in conformity with Article 99(2) of the Treaty  
establishing the European Community

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# **I. GENERAL ECONOMIC POLICY GUIDELINES**

## **1. INTRODUCTION**

The EU has a well-defined economic policy strategy that is oriented towards the pursuit of growth and stability-oriented macroeconomic policies, capable of adequately responding to changing economic circumstances in the short run, and towards improving the long-term capacity for sustainable, job-creating and non-inflationary growth. The 2002 Broad Economic Policy Guidelines (BEPGs) adapt and update this strategy in the light of the political orientations of the Barcelona European Council (15-16 March 2002), also taking into account the development of the sustainable development strategy. They have been drawn up against the background of the examination of the implementation of the 2001 BEPGs and the assessment of the economic situation and outlook as presented in the Commission's Spring 2002 Economic Forecasts.

Section 2 sketches the economic background to these guidelines and identifies the key economic policy challenges. Section 3 then describes the general policy recommendations that are applicable to all Member States and the Community. Within the overall strategy, policy priorities differ somewhat across Member States due to differences in economic performance, prospects, structures and institutions. Taking due account of them, Part II presents the country-specific economic policy guidelines.

In line with the Barcelona European Council's call to streamline relevant processes and to focus on implementation rather than on the annual elaboration of guidelines, the format and frequency of the BEPGs may change as from 2003. Against this background, the 2002 BEPGs opt for continuity with the previous year's edition.

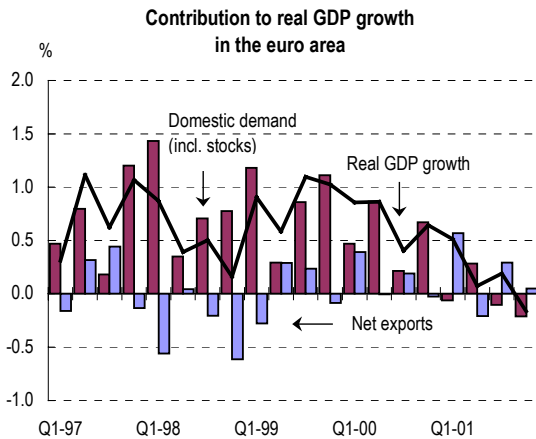
## **2. MAIN PRIORITIES AND POLICY REQUIREMENTS**

### **2.1 *Economic recovery is taking off***

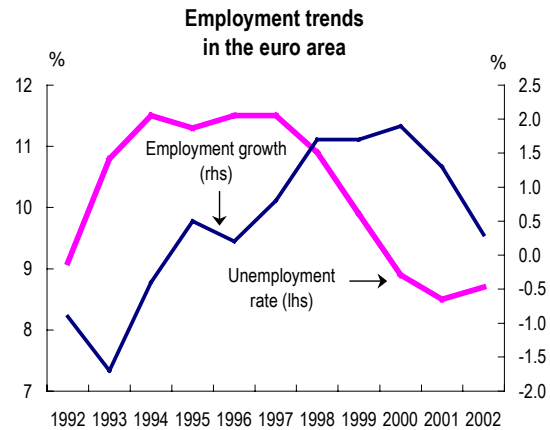
The sharp and unexpected slowdown in economic activity that marked 2001 has shown that the EU economy still lacks resilience. Macroeconomic policies were put to the test and employment growth decelerated.

However, there are now increasing signs that the economy is in the first stages of a recovery. Some leading indicators signal that the economic situation is stabilising. The swift and decisive response of economic policy, sound fundamentals, a restoration of confidence, allied with the unwinding of the impact of a series of adverse economic shocks, provide the platform for recovery. The smooth introduction of the euro in 1999 and the notes and coins in 2002 brings a welcome note of stability and confidence. Notwithstanding persisting downside risks and uncertainty, expectations are that the EU economy is at the brink of an economic recovery. It would gather strength to reach a growth rate close to or above potential in the second half of 2002 and into 2003, i.e. at the time when the recommendations in these guidelines are to be implemented.

As labour market developments reflect the economic situation with a lag, employment and unemployment trends are unlikely to improve visibly before 2003. It is expected that inflationary pressures remain contained over the medium term and that, in the course of 2002, HICP inflation will stabilise at levels below 2%.



Source: Commission services.



Source: Commission services.

## 2.2 Key challenges ahead

The main challenge for economic policy in the EU is to improve the well-being of its current and future citizens. To this end, policies should be geared at achieving a balanced and sustainable expansion of economic activity. The Lisbon European Council has reflected this main challenge in the overarching objective of making Europe the most competitive and dynamic knowledge-based economy by the year 2010, capable of sustainable growth with more and better jobs and greater social cohesion. These goals can only be brought about by balanced efforts on both the economic and social fronts.

Sound fundamentals and the absence of major economic imbalances put the economy in a good starting position. Progress in structural reforms to date has contributed to the strong economic performance and job creation over recent years. The challenge is now to build upon these achievements and to further strengthen the basis for future growth. The imminent enlargement makes it all the more urgent for the EU to be sufficiently dynamic and flexible both to offer an economic model and to rise smoothly to the inherent challenges.

Despite the progress already made, the rate of potential growth remains moderate, limiting the economy's leeway for a full-blown recovery before capacity constraints result in upward price pressures. Moreover, in the long run, when labour supply will get tighter as the effect of ageing populations sets in at full force, the potential growth rate would tend to decline in the absence of measures to accelerate productivity and enhance labour force participation and employment.

The pace of economic reform needs to be stepped up to attain an outstanding economic performance and to meet the challenges set by the Lisbon agenda so as to regain the conditions for full employment. Action would have to concentrate on four areas: i) safeguarding and further strengthening the macro-economic framework; ii) promoting more and better jobs, raising labour force participation and addressing persistent unemployment; iii) strengthening conditions for high productivity growth; and iv) promoting sustainable development in the interest of current and future generations.

*i. — Safeguarding and further strengthening the macroeconomic framework*

Safeguarding and further strengthening the macroeconomic framework enables an appropriate policy stance in all economic circumstances, thereby providing an environment in which macroeconomic stability is ensured, economic cycles are smoothed and internal dynamism and resilience are reinforced by a culture of entrepreneurship and innovation. Such an environment underpins medium-term growth and increases in prosperity, as the economy can benefit fully from progress with economic reforms.

The recent economic downturn has put macroeconomic policies to the test and has rekindled debate about the appropriate policy reaction. It serves to underline the importance of a clear policy framework and of a quick transition to the medium-term budgetary positions agreed in the context of the Stability and Growth Pact (SGP).

*Clarifying the macroeconomic policy framework*

By maintaining price stability, monetary policy plays an important role both in stabilising output around its trend rate and in creating an environment conducive to strengthening the economy's supply side and potential growth. The commitment to price stability has fostered a culture of stability, reducing uncertainty and promoting wage moderation, thereby providing a necessary basis for an investment-friendly environment. The very stable inflation expectations of below 2% bear witness to this.

A sound budgetary policy is the second pillar of the macroeconomic framework. Given the numerous drawbacks of fiscal fine-tuning to stabilise output, the norm for budgetary behaviour should be to let automatic stabilisers operate freely, thereby avoiding pro-cyclical policy. Besides providing leeway for the free and symmetric play of automatic stabilisers, medium-term budgetary positions in balance or in surplus allow for a steady decline in government debt and interest payments and thereby enhance the capacity to deal with budgetary challenges, inter alia those stemming from ageing populations. This basic policy philosophy is anchored in the SGP, which will facilitate the task of monetary policy to maintain price stability and enlarge its scope for being accommodative.

The growing interdependence of the euro-area economies calls for a regular review of the methods and procedures for co-ordinating macroeconomic policies and for the reinforcement of such co-ordination. Defining general principles that guide economic policy decisions and market expectations would improve the credibility and the transparency of the economic policy framework of the euro area.

### *Completing the transition to sound public finances*

The full benefits of EMU and of the budgetary policy co-ordination arrangements covered by the SGP will only be realised when the transition phase to accomplishing medium term budgetary positions close to balance or in surplus will be completed. Until then, in adverse economic conditions, a trade-off will continue to exist between, on the one hand, budgetary consolidation to prevent breaching the 3% reference value or to attain the medium-term positions and, on the other hand, stabilisation of output fluctuations through the free play of automatic stabilisers. Therefore, efforts need to be stepped up to complete the transition phase towards budgetary positions in close to balance or surplus as soon as possible in all Member States and at the latest by 2004. Beyond providing scope for the free play of automatic stabilisers, budgetary policies should be oriented by the need to improve the quality and the sustainability of public finances. The limited window of opportunity before the effects of ageing come to be felt more forcefully should be used to achieve sound public finance positions.

#### ***ii. — Promoting more and better jobs, raising labour force participation and addressing persistent unemployment***

Analysing EU employment growth in a medium-term perspective, the performance has been strong. Besides favourable macroeconomic conditions, the vigorous job creation witnessed since 1997 also reflects the labour market reforms undertaken by Member States, *inter alia* in the context of the European Employment Strategy and the Broad Economic Policy Guidelines. These include measures to lower the cost of labour and/or to improve the adaptability of the workforce, sustained wage moderation, improved real wage flexibility, and cuts in social security contributions and taxes. Labour markets have also tended to become more flexible, witness the large contribution of the development of part-time and temporary employment to overall job creation.

Despite this impressive performance in the second half of the 1990s, human resources are still under-utilised in the European Union and structural problems remain. Unemployment - and in particular long-term unemployment - is still high in a number of Member States and the expected cyclical increase in unemployment in 2002 must be prevented from becoming structural in nature. Unemployment is often concentrated in the more deprived regions and among the more vulnerable groups of workers. Nevertheless, in a number of Member States, high unemployment coincides with a substantial number of vacancies, and labour market conditions often vary considerably across regions, which points to a mismatch between labour supply and demand, due partly to obstacles to geographical and occupational mobility, as well as a lack of differentiation in wage developments.

Moreover, labour force participation rates, especially for older workers and women, are unsatisfactory and significant efforts are needed to raise employment rates to the Lisbon and Stockholm targets and to prepare for the consequences of ageing populations. Realising the Lisbon targets implies an increase of about 15 million jobs in the EU between 2002 and 2010. To prepare for the impact of ageing, the Barcelona European Council has called for an increase of the effective average retirement age in the EU by about 5 years by 2010.

Forceful continuation of the policy action addressed at reducing unemployment and a comprehensive strategy for increasing participation rates is therefore necessary, as endorsed by the Barcelona European Council. This includes action to strengthen incentives for people to take up work, to enable people to participate in the labour market (e.g. by increasing care facilities for children and other dependants, promoting flexible work organisation, including through part-time formula's, education and training), to improve information about job opportunities, to accompany the return of long-term unemployed through active labour market policies, and to enhance conditions under which enterprises can gainfully employ more labour. Promoting human capital formation in order to provide higher skills, adaptable over the worker's whole life cycle, thereby contributing to better quality in work, can in this context act as a catalyst.

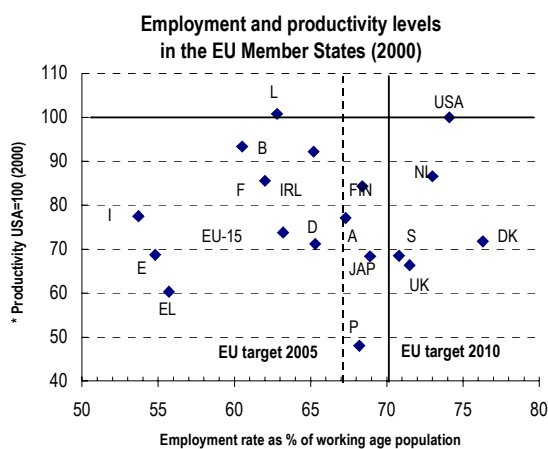
### ***iii. — Strengthening conditions for high productivity growth***

In the long run, the development of the standard of living is broadly determined by the rate of productivity growth. Maintenance of high standards of living in the longer run, as the share of the working age population starts to decline as the result of ageing, will increasingly depend upon productivity increases. Labour productivity growth in the Union is relatively low and has actually slowed by ½ percentage point on average between the first and second half of the 1990s, essentially as a result of job-richer growth on the back of structural reforms. At the cycle's peak in 2000, the rate was back at the average of the early 1990s reaching 1.5%. These rates do not yet allow for sustainable GDP growth rates of 3% that are deemed necessary to fulfil the Lisbon agenda.

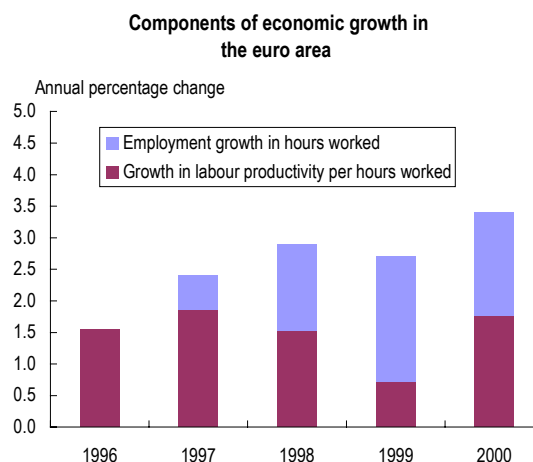
Developments in productivity are the result of many different factors, but depend largely on investment performance, which determines the structure and size of the capital stock and enables the penetration of new technologies in the economy. A higher rate of investment growth raises the capital available per worker and thereby – ceteris paribus – labour productivity. There is both a need and scope to improve the investment environment. The acquired macro-economic stability provides a solid basis for enhancing the investment environment. A high rate of innovation in a context of strong investment growth increases also the quality of the capital stock. Investment and innovation are likely to benefit from a more competitive and entrepreneurial environment, fostered by structural reforms on product, capital and labour markets that improve market functioning and thus the transfer of resources from low-productivity to higher productivity use. Equally important are an adequate regulatory environment, efficient public services, a satisfactory provision of network infrastructure and increased investment in research, education and training to enhance skills and the adaptability of the workforce.

Despite encouraging progress so far, large segments of European product markets are still insufficiently integrated to make the Union an attractive location for investment. Further reforms are needed to integrate energy and communication networks across Europe. To facilitate the cross-border provision of services, especially in the distribution sector, and an increased mobility of both skilled and unskilled workers, increased co-ordination of national and Community policies is required. In financial services and capital markets, EMU has already created new opportunities for efficiency gains. Nevertheless, there is still a long and unfinished agenda to be completed that is set out in various parts of these guidelines.





Source: Commission services. \* Productivity is GDP per person employed.  
 Note: Employment rate data are based on the number of jobs held by individuals irrespective of whether they are full-time or part-time.



Source: Commission services.

#### *iv. –Promoting sustainable development in the interest of current and future generations*

Taking account of the needs of current and future generations, including environmental sustainability and social and regional cohesion, will ensure that policy measures that aim to boost prosperity will contribute fully to increasing the well-being of its citizens. Economic policies can make a significant contribution towards this goal, but its achievement would typically require substantial policy actions in a number of areas, which would tend to go beyond economic policy considerations only. Nevertheless, by taking environmental and social constraints and concerns into account, economic policy makers can optimise their policies.

For instance, economic policies can make a major contribution to enhancing environmental sustainability by making sure that the external effects of economic activities on the environment are fully priced in. Likewise, economic policies can make an important contribution to the adequate preparation for the challenges posed by ageing societies notably where labour market participation and its financial consequences are concerned. The aim is to ensure the positive interaction of economic and social policies with a view to supporting a long-term sustainable working life while making optimal use of the human resource potential.

Finally, economic policies can contribute to social and economic cohesion in various ways. A good economic performance underpins job creation and jobs are the best protection against poverty and social exclusion. A modern and active welfare state that encourages people to work would also be important in this respect. A sound macro-economic framework as well as efficient product, capital and labour markets are important determinants of both national and regional catching-up. Economic policies can be improved in some policy areas by better taking account of specific regional conditions. Facilitating regional labour market adjustment by encouraging the wage formation process to better reflect differences in local conditions and by reducing disincentives to geographic labour mobility is an important step

and should be further pursued. Furthermore, raising the effectiveness of public spending with regional incidence by improving public systems for allocation and delivery should also be given further consideration.

### **3. POLICY RECOMMENDATIONS**

#### **3.1 *Ensure growth and stability-oriented macroeconomic policies***

*Macro-economic policy plays a key role in sustaining growth and employment and in preserving price stability. Over the short term, it should aim at the continuation of a well-balanced economic expansion and the full realisation of current growth potential. Over the medium term, it should contribute to the establishment of the framework conditions that promote adequate levels of saving and investment to position the economy on a sustained, higher, non-inflationary, growth and employment path.*

*In the **euro area**, following the precipitous decline in economic activity in 2001, growth is expected to recover and reach rates close to or above potential in the second half of the year, whilst inflation should decline. An appropriate and tension-free macroeconomic policy approach consists of the following elements.*

*The primary objective of the single monetary policy is to maintain price stability in the euro area. Without prejudice to this objective, it supports the general economic policies in the Community.*

*Member States should achieve and preserve a sound budgetary position as agreed in the context of the Stability and Growth Pact. To put public finances on a durably sound footing, all Member States need to ensure that cyclically-adjusted budgetary positions move towards, or remain in, balance or surplus in the coming years. Sustaining sound budgetary positions implies that tax reforms need to be properly financed, and matched with reductions in public expenditures where appropriate. Sound and sustainable public finances contribute to low interest rates and to the crowding-in of private investment. It creates room for manoeuvre for cyclical stabilisation, to cope with unexpected budgetary developments and puts government debt on a more rapidly descending trajectory with a view to prepare for the budgetary challenges associated with population ageing. Finally, by increasing the credibility of the budgetary framework of EMU, they contribute to a strengthening of investors' confidence.*

*As a general principle, it is important that budgetary policies be guided by the need to avoid pro-cyclical stances, which can exacerbate swings in economic activity, lead to unsustainable structural balances and undermine the price-stability orientation of the single monetary policy. The norm for budgetary policies should therefore be to allow for the symmetric play of automatic stabilisers over the economic cycle, subject to the respect of the 3% of GDP excessive deficit limit. During upturns, Member States should allow automatic stabilisers to operate in full thus implying improved budget balances.*

<b>Projections for general government surplus(+)/deficit(-)</b> (% of GDP)							
	<b>2000<sup>2)</sup></b>	<b>Date<sup>1)</sup></b>	<b>2001<sup>2)</sup></b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>
<b>Stability programmes</b>							
B	0.1	12/-01	0.0	0.0	0.5	0.6	0.7
D	1.2(-1.3)	12/-01	-2½	-2	-1	-0	-0
EL	-1.1	12/-01	0.1	0.8	1.0	1.2	
E	-0.3	12/-01	0.0	0.0	0.0	0.1	0.2
F	-1.4	12/-01	-1.4	-1.4	-1.3/-1.0	-0.5/0.0 <sup>3)</sup>	0.0/0.3
IRL	4.5	12/-01	1.4	0.7	-0.5	-0.6	
I	(-1.5)	11/-01	-1.1	-0.5	0.0	0.0	0.2
L	6.2	11/-01	4.1	2.8	3.1	3.4	
NL	2.2(1.5)	10/-01	0.7	0.4	0.2	0.5	
A	-1.1	11/-01	0.0	0.0	0.0	0.2	0.5
P	-1.5	12/-01	-2.2	-1.8	-1.0	0.0	0.4
FIN	6.9	11/-01	4.7	2.6	2.1	2.6	
Euro area	-0.8		-1.1	-0.9	-0.5	0.0	0.1
<b>Convergence programmes</b>							
DK	2.5	01/-02	1.9	1.9	2.1	2.1	2.1
S	4.1	11/-01	4.6	2.1	2.2	2.3	
UK <sup>4)</sup>	2.0	12/-00	-0.2	-1.1	-1.3	-1.1	-1.0 <sup>5)</sup>
EU-15	-0.1		-0.8	-0.9	-0.6	-0.1	-0.1

1) Dates of adoption by Member States government of updated stability or convergence programme. 2) Government balances in 2000 or 2001 are affected by receipts from the sale of UMTS licences in several countries. Where relevant and where information is available, two figures are shown: the first includes the proceeds from UMTS licences and the second (in brackets) excludes these proceeds. 3) Government deficit of 0.5% of GDP in 2004 projected in a more prudent growth scenario. 4) Financial years. 5) Government deficit of 1.0% of GDP also projected for 2006-07.

**Source:** Member States' stability and convergence programme updates and Commission services.

*Based on the latest 2001/02 updates of the stability programmes, following a slight deterioration in 2001, the aggregate euro-area budgetary position is set to improve gradually to a balanced position in 2004, one year later than foreseen in last year's BEPGs due to diminished growth conditions.*

*In general, euro-area Member States should:*

- i. orient and implement their budgetary policies so as to achieve or maintain budgetary positions of close to balance or in surplus over the economic cycle; if budgetary positions of close to balance or in surplus are not yet achieved, take all the necessary action - in the context of the implementation of the budgets for 2002 and the preparation of budgets for 2003 - to ensure that such medium-term objectives are respected by 2004 at the latest;
- ii. ensure that tax reforms are financed appropriately in order to safeguard the commitment to sound public finances; avoid pro-cyclical fiscal policies thus contributing to an appropriate macroeconomic policy mix at the national and euro-

area level; allow automatic stabilisers to operate in full as the recovery gets underway; ensure a rigorous execution of their budgets so as to prevent slippage from the stability programme targets; and

- iii. further strengthen public finances with a view to secure their long-term sustainability by making use of the limited window of opportunity prior to the demographic changes taking hold.

*Regarding the **non-euro-area Member States**, monetary policy in Denmark is guided by the fixed-exchange rate policy toward the euro in the framework of ERM2, which is seen as instrumental to achieve price stability. In Sweden and the United Kingdom monetary policies aim at price stability through targeting inflation. Their successful achievement will help create the conditions for exchange rate stability.*

*The non-euro-area Member States shall also maintain sound budgetary positions in accordance with the Stability and Growth Pact. In general, they should:*

- i. orient and implement their budgetary policies so as to maintain budgetary positions of close to balance or in surplus over the economic cycle;
- ii. ensure that tax reforms are financed appropriately in order to safeguard the commitment to sound public finances; avoid pro-cyclical fiscal policies thus contributing to an appropriate macroeconomic policy mix at the national level; allow automatic stabilisers to operate in full as the recovery gets underway; ensure a rigorous execution of their budgets so as to prevent slippage from the convergence programme targets; and
- iii. further strengthen public finances with a view to secure their long-term sustainability by making use of the limited window of opportunity prior to the demographic changes taking hold.

***Wage developments** in Member States should reflect different economic and employment situations. Governments should promote the right framework conditions for wage negotiations by social partners. For wage developments to contribute to an employment-friendly policy-mix, social partners should continue to pursue a responsible course and conclude wage agreements in Member States in line with the general principles set out in the Broad Economic Policy Guidelines. It is necessary that:*

- i. the increase in nominal wages be consistent with price stability;
- ii. the increase in real wages not exceed growth of labour productivity taking into account the need to strengthen, where necessary, and subsequently maintain, the profitability of capacity-enhancing and employment-creating investment; and
- iii. national labour institutions and collective bargaining systems, respecting the autonomy of social partners, take into account the relationship between wage developments and labour market conditions, thereby allowing an evolution of wages according to productivity developments and skills differentials, in order to guarantee

the EU's competitiveness and to improve employment across skills and geographical areas.

### **3.2 *Improve the quality and sustainability of public finances***

*To maximize the contribution of public finances to growth and employment and the achievement of the objectives agreed in Lisbon and Stockholm, all Member States must achieve and sustain sound budgetary positions. This is especially important in countries that have yet to achieve budget positions that are “close to balance or in surplus” as required by the Stability and Growth Pact. An appropriate balance and sequencing have to be drawn between running down public debt, cutting taxes and continuing to financing public investment in key areas. Countries with a high level of public debt and/or that have not yet reached the medium-term budgetary target of the Pact should give priority to budgetary consolidation: this will ensure that there is sufficient room for the automatic stabilisers to operate in the event of an economic downturn and will help countries prepare for the additional budgetary costs of ageing populations. The assessment of the sustainability of public finances on the basis of updated stability and convergence programmes confirms that there is a substantial risk of budgetary imbalances emerging in the future due to ageing populations in many Member States.*

*To this end Member States should:*

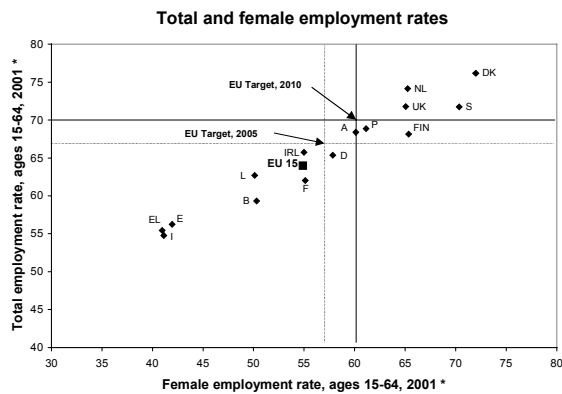
- i. pursue efforts to make tax and benefit systems more employment friendly, including, where appropriate, a reduction of the overall tax burden, targeted reforms of the tax and benefit systems, especially with respect to low-wage labour, within continued fiscal consolidation, and by improving the efficiency of tax systems (see also section 3.3);
- ii. promote the quality of public expenditure by redirecting towards physical and human capital accumulation and research and development so as to ensure substantial annual increase of per capita investment;
- iii. enhance the efficiency of public spending by institutional and structural reforms; in particular introduce or enhance the mechanisms that help assess and control spending, including budgetary procedures;
- iv. improve the long-term sustainability of public finances by pursuing a comprehensive three-pronged strategy agreed by the Stockholm European Council. This involves a suitable combination of measures to run down public debt at a fast pace, raise employment rates (especially amongst women and older workers), and reform pension and care systems with a view of placing them on a sound financial footing. Public pension reserve funds could also contribute to improving the sustainability of public finances, provided they receive regular and substantial contributions. Strengthen their capacity to evaluate the long-term sustainability of public finances and factor these analyses into medium-term budgetary planning processes. This will help reinforce examination in the context of multilateral surveillance as asked by the Barcelona European Council;

- v. reform pension policies towards the broad common goals agreed by the Gothenburg and Laeken Councils so as to safeguard the adequacy of pensions, maintain the financial sustainability, and meet changing societal needs; develop a comprehensive strategy that takes due account of the balance between these broad objectives and challenges faced by individual countries; in particular introduce measures that aim at increasing the effective retirement age (by restricting access to early retirement programmes, by removing unwarranted financial biases in tax and pension systems for older workers to leave the labour force early, and by allowing more flexible formulas regarding the retirement age), making the pension systems cope better with demographic risks and expected increases in life expectancy, making the pension systems transparent regarding contributions and benefits and moving towards a greater reliance on actuarial fairness and funding, so as to achieve a better balance between the different pillars within the pension systems in those Member States which have not yet achieved that; and
- vi. pursue tax co-ordination further so as to avoid harmful tax competition and implement effectively the Council agreement of November 2000 on the tax package with a view to meeting the December 2002 deadline for agreement.

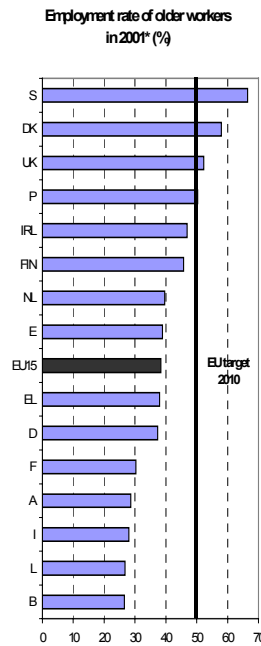
### **3.3 *Invigorate labour markets***

*Despite the impact of the cyclical slowdown, the labour market situation continued to improve in 2001, even though the very positive developments of the preceding year could not be repeated. The average unemployment rate of 7.6% was 0.5 percentage points below the 2000 average (see chart on unemployment rate). Progress towards the employment goals set by the Lisbon and Stockholm European Councils continued in 2001, although it was more moderate than the year before. The overall employment rate now stands at 64%, the employment rate of women at 55% and that for older workers (aged 55-64) at 38% (see charts on overall, female and older workers employment rates).*

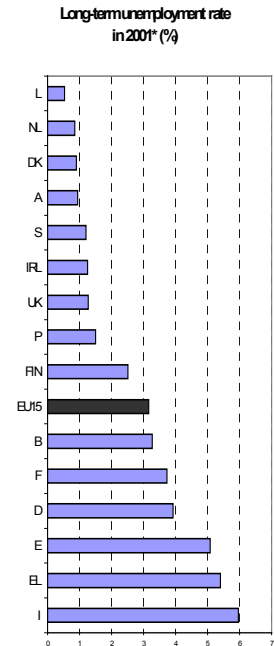
*Progress achieved over previous years with structural reforms of labour markets, also in the context of the European Employment Strategy, has become visible in more employment-intensive growth. Sustained wage moderation has allowed employment to increase significantly and unemployment to fall without resulting in a boost to inflation; a greater use of temporary and part-time contracts has contributed to making labour markets more flexible and inclusive; tax reductions targeted to the low end of the wage distribution have improved incentives to take up a job; and Member States have started to move away from passive towards active labour market measures. Unfortunately, the pace of labour market reforms seems to have slowed down in 2001.*



\* Data for D, F and L are for 2000. D is estimated. Note: Employment rate data are based on the number of jobs held by individuals irrespective of whether they are full-time or part time. Source: Commission services.



\* Data for D, F and L are for 2000. Dis estimated.



\* Data for D, F and L are for 2000. Dis estimated.

However, important challenges remain that need to be addressed through further reforms. In line with the discussion in Section 2.2. ii, the challenges include:

- promoting more and better jobs;
- increasing participation rates further, especially for women and older workers, in order to meet the Lisbon-Stockholm targets for employment and to prepare for the consequences of ageing populations;
- reducing high unemployment rates;
- reducing the mismatch between demand for and supply of labour across regions and occupations.

These challenges should also be seen in conjunction with other challenges directly relevant for the labour market, such as wage formation and education and training, taken up in sections 3.1 and 3.7, respectively. On 18 February 2002, the Council adopted detailed guidelines for employment policies for the year 2002, consistent with the priorities in the 2001 Broad Economic Policy Guidelines, as well as Member State specific recommendations therein. In pursuing labour market reforms, Member States should vigorously implement the Employment Guidelines and the recommendations addressed to them.

*Member States should, in particular, take the following measures:*

- i. adapt tax and benefit systems to make work pay and encourage the search for jobs. Reduce high marginal effective tax rates, in particular for low wage earners, and remove unemployment traps. Address incentive effects of benefit schemes, including conditionality of benefits, eligibility, duration, the replacement rate, as well as availability of in-work benefits and the use of tax credits, in order to make the systems more employment friendly; in addition, review administrative systems and management rigour. Reduce incentives for early retirement. Step up efforts to increase opportunities for older workers to remain in the labour market, in order to increase by about five years the effective average retirement age in the EU by 2010, thereby increasing their labour market participation;
- ii. strengthen active labour market policies, by improving their efficiency both regarding the use of resources and their effectiveness in terms of increasing regular employment. This implies, *inter alia*, better targeting them to those individuals most prone to the risk of long-term unemployment, on those measures that have proven most successful and to meet the demands of the labour market;
- iii. bring down obstacles to mobility within and between Member States. Along the lines of the Action Plan Skills and Mobility, foster the recognition of qualifications, facilitate the transferability of social security and pension rights, improve information and transparency on job opportunities and ensure that tax and benefit systems, as well as housing markets, do not inhibit mobility;
- iv. facilitate occupational mobility by improving lifelong learning, in dialogue with the social partners, thereby also contributing to better job quality and higher productivity;
- v. promote, in dialogue with the social partners, more flexible work organisation and review employment contract regulations and related costs, with the aim of promoting more jobs and striking a proper balance between flexibility and security. Ensure that any reductions in overall working time do not lead to increases in unit labour costs, and that the future labour supply needs are taken fully into account; and
- vi. remove existing barriers to female labour market activity. Increase the provision of care facilities for children and other dependants, *inter alia* in order to reach the childcare targets agreed at the Barcelona European Council (i.e. to provide childcare by 2010 to at least 90% of children between 3 years old and the mandatory school age and at least 33% of children under 3 years of age). Address the underlying factors that lead to a gender pay gap.

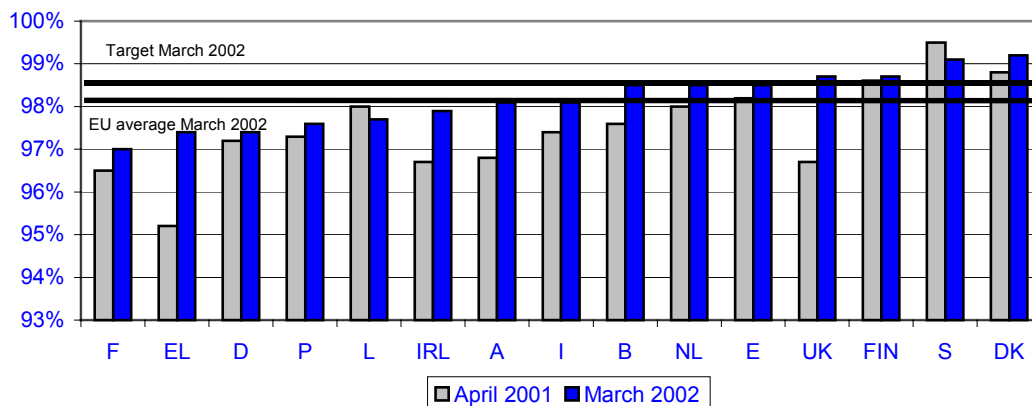


### 3.4 ***Re-ignite structural reform in product markets***

*Progress in implementing the economic reform agenda of the Lisbon strategy has been mixed. Progress has been made in transposing Internal Market directives into national legislation, in opening up public procurement, in reinforcing the powers of the competition authorities, and in reducing State aid. The liberalisation of the telecommunication and electricity markets has started to result in price reductions. Similarly, positive effects are expected from the increased access to rail freight networks. However, prospects for further price declines are likely to be affected by physical bottlenecks, inadequate regulatory structures, slow market opening, and the high market shares of incumbents in these sectors. This illustrates that to create a fully integrated and efficient Internal Market, further reforms on product (goods and services) markets are needed, particularly in areas where progress has been too slow. In spite of the fact that EU goods markets are becoming increasingly integrated, differences in standards and regulations continue to hinder cross-border activities. Moreover, the creation of an Internal Market for services has advanced only slowly. In light of the above, Member States should:*

- i. fully implement the Internal Market:
  - step up efforts to increase the transposition rate of Internal Market directives to 98.5%, achieve full transposition by the Spring European Council in 2003 of directives whose implementation is more than two years overdue, and ensure the correct implementation of Internal Market legislation;
  - pursue more vigorously the elimination of remaining technical barriers to trade by speeding up the development of new product standards and improving the application of the mutual recognition principle by national administrations;
  - create an effectively functioning Internal Market in services by the removal of barriers to cross-border trade and market entry; and
  - further open up and render more transparent public procurement markets, *inter alia*, by bringing it online by 2003 and by adopting the public procurement legislative package as early as possible in 2002.

## Internal Market directives - Transposition rate



Source: European Commission

- ii. ensure effective competition, thereby delivering real benefits to consumers:
  - ensure effective independence, adequate capacity and effectiveness of the competition and regulatory authorities and enhance the coherence of the application of competition rules by the Commission and the national competition authorities; and
  - continue to reduce the overall level of State aid in relation to GDP and redirect aid toward horizontal objectives of common interest and target it to identified market failures. Increase the transparency of State aid policies and assess their effectiveness.
  
- iii. accelerate reforms in the network industries, while complying with universal service obligations:
  - encourage market entry and improve consumer choice in liberalised markets, in particular by fully implementing the new communications regulatory package by July 2003;
  - in electricity and gas, ensure freedom of choice of supplier as of 2004 for all non-household consumers (amounting to at least 60% of the total market) and establish a regulatory function. The level of electricity interconnections between Member States should be equivalent to at least 10% of their installed production capacity by 2005;
  - ensure efficient use of existing infrastructure and provide incentives to build new infrastructure where necessary by taking decisions by the end of 2002 on the revision of the guidelines and accompanying financial rules on trans-European energy and transport networks; and

- in transport, take decisions by the end of 2002 on proposals concerning airport slot allocation, port services and public services contracts; create a Single Sky by 2004; open the trans-European rail freight network up to competition by 15 March 2003 and pursue work on the second railway package.

### **3.5 Promote the efficiency and integration of the EU financial services market**

*Financial integration improves economic performance by improving resource allocation, fostering greater competition and reducing the exposure of the EU economy to external shocks. While financial integration has benefited from the introduction of the euro, the EU financial system remains highly fragmented. Cross-border financial activity is constrained by a range of barriers that reflect the existence of many national-based financial systems with varying characteristics. A notable example of fragmentation is the current arrangements for clearing and settlement in the EU, which are largely efficient at the national level but are highly inefficient in a cross-border context.*

*The main instrument for creating an integrated EU financial system is the Financial Services Action Plan (FSAP). The FSAP proposes an extensive set of measures designed both to complete the legislative framework for the single market in financial services and to ensure that it is appropriate to markets that are constantly changing. Significant progress has been made in implementing the FSAP, but sustained efforts are necessary to ensure implementation ahead of the 2005 deadline established by the Lisbon European Council.*

*The Risk Capital Action Plan (RCAP) is the blueprint for developing an integrated and efficient market for equity financing of young and innovative businesses. The RCAP contains a set of measures (many in common with the FSAP) in respect of private equity (venture capital and buy out) that promote market integration, enact structural reform in areas such as regulation, taxation and bankruptcy law and foster a culture of enterprise. The Lisbon European Council has set a deadline of 2003 for the implementation of the RCAP.*

*Integration will enhance financial stability within the EU so long as institutional arrangements for prudential supervision are adequate. In response to ongoing consolidation within and across financial sectors, several Member States have reformed or are in the process of reforming their supervisory arrangements. The choice of arrangements varies among Member States, which is likely to increase the need for clear procedures for cross-border co-operation between different national supervisors.*

*In order to accelerate progress in financial integration, there will be a need to:*

- step up efforts by all relevant parties - the Council, the European Parliament, the Commission, and the Member States - to ensure full implementation of the FSAP by 2005, and by 2003 for securities markets legislation; therefore, as highlighted by the European Council in Barcelona, the Council and the European Parliament need in particular to adopt as early as possible in 2002 the proposed Directives on Collateral, Market Abuse, Insurance Intermediaries, Distance Marketing of Financial Services, Financial conglomerates, Prospectuses and Pension Funds, and the International Accounting Standards Regulation; The Member States should ensure, as soon as

possible, the implementation of legislation already adopted by the Council (e.g. the Regulation preventing excessive charges on cross-border payments in the retail sector);

- ii. intensify efforts to implement the RCAP by 2003, in particular with regard to favouring a “prudent man” approach rather than limits by asset type in the regulation of institutional investment, reforming bankruptcy procedures to provide a better balance between entrepreneurial activity and investor protection, and developing a fiscal framework more conducive to investment and entrepreneurship; and
- iii. to ensure that there are appropriate arrangements at national and Community level to deliver efficient cross-border / cross-sector co-operation, co-ordination and exchange of information among the various supervisory authorities.

### **3.6 Encourage entrepreneurship**

*Increased business investment is necessary to improve the productivity and raise the level of potential growth of the European economy. The creation of a competitive business environment supported by adequate public infrastructure and a modern and efficient public administration is key to stimulating business creation and expansion. This has been recognised by all Member States, as illustrated by the variety of measures taken to reduce the regulatory burden on business, to stimulate business creation, and to ease access to finance for SMEs. The European Charter for Small Enterprises endorsed at the Feira European Council (June 2000) should also contribute to supporting small businesses. Nevertheless, differences in business conditions between Member States – in particular in the area of taxation - remain important. This offers a wide scope for learning from best practice examples. Member States should:*

- i. create a business-friendly environment:
  - improve and simplify the corporate tax system and the regulatory environment. Reduce administrative and legal barriers to entrepreneurship to the barest minimum, in particular through a reduction of the typical time and cost required for setting up a new company;
  - increase the efficiency of public services, *inter alia* via increased use of public tendering and benchmarking; increased participation of the private sector and competition between public service operators; and by making government services available online; and
  - reduce barriers to cross-border economic activity associated with, among other things, differences between Member States in accounting standards, rules on corporate governance, business taxation and VAT.
- ii. translate into action the commitments made under the European Charter for Small Enterprises.

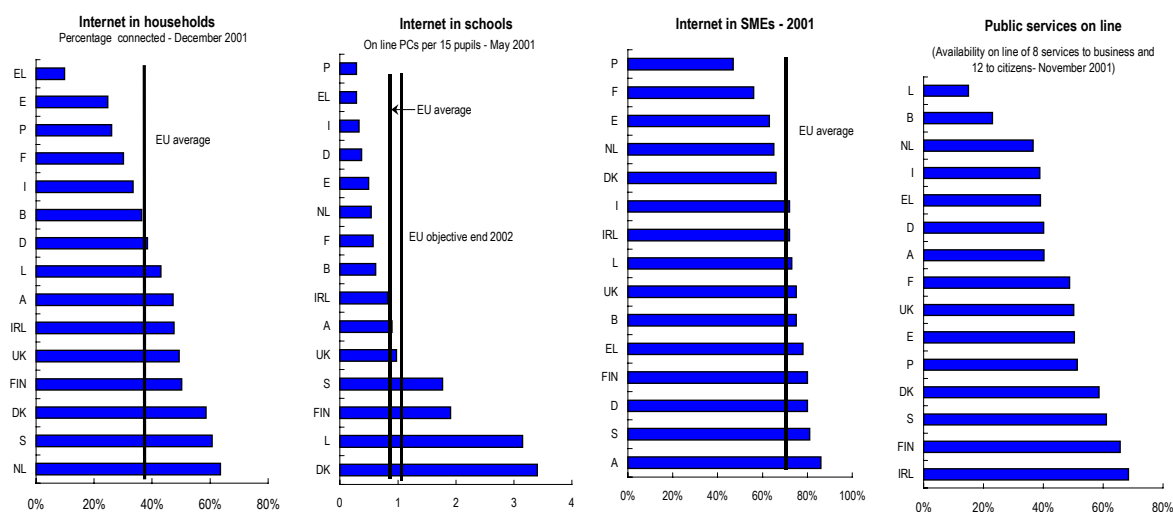
- iii. encourage risk-taking through improving access to finance especially for SMEs in their early stages. Particularly important for SMEs is the supply of capital coupled with managerial skills (see also Section 3.5).

### **3.7 Foster the knowledge-based economy**

*In spite of recent progress, the European Union continues to lag behind the United States in both the development and diffusion of new technologies. Moreover, there are important differences between Member States, both in terms of R&D expenditures as a percentage of GDP and the number of patent applications per head of the population. Increased investments in human capital, R&D and ICT, by the private sector in particular, are required in order to strengthen European competitiveness. In this respect, the Union's recently approved Galileo satellite radio-navigation project constitutes a major step forward. Businesses and citizens need to be encouraged to seize the opportunities offered by the knowledge-based economy. Education and training systems need to become better adapted to the needs of those typically disadvantaged in the labour market. This implies that Member States should:*

- i. stimulate R&D and innovation:
  - raise overall spending on R&D with the aim of approaching 3% of GDP by 2010. Two-thirds of this investment should come from the private sector. This implies improving the incentives for firms to invest in R&D through an integrated strategy aimed at raising the level of competition on product markets, providing better access to risk capital, better protecting intellectual property rights (including the creation of an affordable Community patent) while ensuring more rapid diffusion of new technologies, and using fiscal and other financial incentives;
  - improve ties between universities and business leading to knowledge transfer and a better commercialisation of R&D results. Establish clear and consistent priorities for public research; and
  - enhance collaboration on research and innovation across Europe.
- ii. promote access and use of ICT:
  - ensure effective competition in local telecommunication networks (the 'local loop') in order to speed up the development of the European broadband network; and
  - stimulate internet use across all strata of society (i.e. in households, schools, enterprises and public administrations) and, in particular, raise the ratio of internet-connected PCs to pupils to one for every fifteen pupils.

## Use of Internet



Source: Commission services, ENSR Survey 2001, Observatory of European SMEs, European Commission (study by Cap Gemini Ernst & Young).

### iii. strengthen education and training efforts:

- both private and public, in order to increase the supply of trained researchers, to increase the number of highly qualified ICT personnel, and to improve the general level of educational attainment of the population and ensure that all citizens have access to basic skills;
- enhance the capabilities of education and training systems to respond adequately to changes in skill requirements, and in particular to meet the needs of groups typically disadvantaged in the labour market such as women, older workers or early school leavers; and
- introduce instruments to ensure the transparency of diplomas and qualifications.

## 3.8 Enhance environmental sustainability

*Protection of environmental resources such as clean air, water and soil, maintaining biodiversity and reducing environmental threats to public health require an active environmental policy in order to ensure a responsible use of scarce natural resources and development which is economically, environmentally and socially sustainable in the long run. Commitments undertaken at international level - notably in the area of climate change - also call for policy action.*

*The Stockholm European Council has asked to integrate the promotion of sustainable development into the Broad Economic Policy Guidelines. As further emphasised by the Gothenburg European Council, sustainable development is a concept that goes beyond a purely economic assessment and strives for improvements in the quality of life by promoting*

*coherent policy actions based on an overarching assessment of the economic, social and environmental dimension. In doing so, it takes a long-term view, looking at the welfare of both present and future generations. Concrete priority actions have been identified for the different policy areas. This section focuses on the integration of environmental aspects into economic policy, in particular the use of market-based instruments, as a means of promoting sustainable development.*

*Government action is often delayed by concerns about possible short-term consequences of policies to protect the environment on economic growth, employment and on the competitiveness of individual firms, sectors and Member States. In this context, while considering the full range of policy instruments in pursuit of environmental, economic and social objectives, Member States should make increased use of economic instruments in pursuit of environmental objectives without putting other policy objectives in jeopardy. These instruments provide flexibility to industry to reduce pollution in a cost-effective way, and encourage technological innovation. Furthermore, they are often the most efficient means to curb pollution since they lead to the internalisation of external costs in prices. They are therefore a way to implement more consistently and cost-effectively the polluter-pays principle. In this respect, better information of the citizens and firms involved and a proper evaluation of instruments are important. Investment in new, environmentally friendly technology can also be an important source of progress.*

*Member States should set clear targets and timetables for their policies, such as those approved by the European Council in Gothenburg in this context, and apply them consistently so that business and consumers can adjust smoothly. Continued action is needed every year to bring about a gradual decoupling of economic growth from resource use, in particular between transport growth and GDP growth. Co-ordinated and gradual but steady and credible changes in the level and structure of tax rates until external costs are fully reflected in prices would minimise structural adjustment problems and support adaptation and innovative solutions by firms. This approach would also minimise the need for exemptions for those firms or sectors that are most affected. Such exemptions often reduce the environmental effectiveness of the measure, distort the tax structure and are difficult to remove at a later date. Establishing a framework for the use of economic instruments at Community level could help avoid such distortions and underpin the Internal Market.*

*Accordingly,*

- i. Member States should introduce and strengthen policies based on economic instruments like taxation, user and polluter charges, insurance/liability schemes and tradable emission rights. A key sector for such a policy is the transport sector with its different modes, which still lacks an adequate consistent and integrated system of user charges and taxes in order to appropriately integrate externalities and mirror resource use;
- ii. in order to fulfil the requirements of the Kyoto protocol in a cost-effective way, Member States should prepare for the introduction of emissions trading at EU level by ensuring *inter alia* that they have in place sufficiently robust procedures for monitoring, reporting and verification of emissions. Those Member States which have already established emissions trading schemes for greenhouse gases, or which are

considering doing so, should ensure that their schemes are compatible with the Community scheme currently under discussion in the Council. Member States should start to develop their national allocation plans, and establish clear rules governing allocation of emission allowances both to individual entities and to the emissions trading scheme as a whole. More generally, Member States should ensure that their domestic climate change policies and measures do not hinder the establishment of a EU-wide emissions trading scheme and should also prepare other measures and policies, in particular aiming at more efficient management of energy and transport demand;

- iii. Member States should encourage the disclosure of environmental information in the annual accounts of companies in line with the Commission Recommendation of 30 May 2001;
- iv. Member States should prepare legislation that requires companies involved in environmentally sensitive activities to provide financial assurance for potential damages they might cause;
- v. Member States should reduce sectoral subsidies and tax exemptions and other measures, which have a negative environmental impact;
- vi. Member States should agree by December 2002 on an appropriate framework for energy taxation at the European level; and
- vii. in order for the European Union “to show substantial progress in enhancing energy efficiency by 2010”, as requested by the Barcelona European Council, Member States should continue to implement measures targeted on energy use, including transport.



## II. COUNTRY-SPECIFIC ECONOMIC POLICY GUIDELINES

### 1. BELGIUM

The Belgian economic activity experienced a sharp deceleration in 2001, real GDP growth reaching 1%, after an exceptional year 2000 when the economy expanded by 4%; the slowdown in world trade and the resulting deterioration in business confidence were the main reasons for this development. Economic activity is currently expected to recover gradually in the first quarters of 2002 and more firmly in the second half of the year, both export and import volumes resuming dynamism; however, real GDP growth, on average, is not expected to exceed the result of the preceding year. In 2003, the economy should expand by slightly below 3%, as a result of more buoyant international trade and more robust domestic demand. Inflation, as measured by the HICP, is expected to decelerate to clearly below 2% in 2002, from 2.5% in 2001, and remain contained in 2003. Employment is projected to rise in 2003, although at a more modest rate compared to recent past; unemployment is expected to increase somewhat in 2002 but should resume a falling trend in 2003. Wage developments would remain moderate in the context of the new framework wage agreement to be concluded, by the end of 2002, for the period 2003-2004.

Although declining, the government debt ratio to GDP is still at a very high level in Belgium and requires further budgetary adjustment, in particular in view of ensuring the sustainability of public finance in a context of ageing populations. Pension reform must also be pursued, in particular of early retirement regulations, the complementary pension and the reinsertion of pensioners in the labour market, in order to face this challenge. The low employment rate, the high regional differences in unemployment, the lack of competition in specific service sectors, the administrative burden on business and the lack of efficiency in the public administration represent other areas requiring attention.

#### *Budgetary policy*

In spite of the sharp slowdown in economic activity in 2001, the general government accounts were in balance (or in a surplus of 0.2% of GDP including the UMTS licences receipts); instrumental in maintaining a general government balance was a high primary surplus, at 6.6% of GDP, reached through retrenchment in primary expenditure and buoyant tax revenues; specific factors, such as real estate sales, contributed by about 0.3% of GDP to this result. The 2001 update of the stability programme targets a general government balance in 2002, and a surplus of 0.5% of GDP in 2003. Maintaining high primary surpluses of the order of 6% of GDP per year remains an essential element of the budgetary adjustment strategy, given the still very high level of the government debt and in view of the challenges in the long term induced by the ageing population. A limit on real expenditure growth of Entity I (federal government and social security) to 1.5% per year is considered appropriate to achieve this objective. The decline in the government debt ratio was modest in 2001, a development due mainly to low nominal GDP growth and to ad hoc factors; the government debt ratio is projected to fall to marginally below 100 percent of GDP at the end of 2003. In view of the above, and considering that Belgium is a member of the euro area, budgetary policy should aim to:

- i. in 2002, do not allow a deterioration in the government balance compared to 2001, notably through containment of government current expenditure;

- ii. resume budgetary consolidation in 2003 and achieve a 0.5% of GDP general government surplus by adhering to the 1.5% limit on real expenditure growth for Entity I and by strict budgetary surveillance of all parts of government; and
- iii. define a comprehensive strategy in order to prepare for the budgetary implications of population ageing; this strategy should aim at further reducing the debt level, reforming the pensions system, addressing in particular the low average effective retirement age and quantifying the budgetary resources to be allocated annually to the Ageing Fund.

### ***Labour markets***

The Belgian labour market was affected by weaker economic growth in 2001. The rapid decline in the unemployment rate recorded over the previous two years gradually came to a halt and it is now projected to increase somewhat in 2002. Although the overall employment rate grew steadily over the second half of the nineties, rising from 56.3% in 1996 to about 61% at the end of 2000, it is still below the EU average, mainly because of relatively lower rates for young (29% for those aged 15-24), older persons (only 24% for those aged 55-64), and women (51.5%). Within the framework of the “active welfare state” approach, the gradual shift from passive policies to preventive and more active measures continued in 2001. Notwithstanding measures already implemented, benefit dependency is still relatively high for some segments of the labour market and other measures could be taken to remove the remaining “unemployment traps” and “activate” the still sizeable number of working age benefit recipients, especially older workers, not in employment. Regional differences remain noticeable. The employment rate in the Flanders (about 64% in 2000) was still 8-9 percentage points higher than in Wallonia and the Brussels region. This reflects inadequate labour mobility and insufficient wage flexibility. Linguistic barriers, high housing costs (due to remaining heavy registration taxes), increasing traffic congestion, an inadequate public transportation network, are the main obstacles to mobility. In view of the above, while vigorously implementing all the Employment Recommendations adopted by the Council in February 2002, the main priorities for Belgium should be to:

- i. consolidate recent reforms of the tax and benefit systems to reduce benefit dependency and make work pay, in particular, by removing the remaining disincentives for older people to continue to work or re-enter the labour market;
- ii. take action to increase labour mobility and encourage Social Partners to allow wage-setting mechanisms to better take into account productivity and local labour market conditions, while preserving wage moderation;
- iii. promote a proper balance between flexibility and security, and monitor closely the impact on labour supply of recent initiatives to increase working-time flexibility, in particular the new time-credit system; and
- iv. intensify efforts to increase the employment rate for women by removing disincentives to their entry or re-entry to the labour market.

### ***Product markets, entrepreneurship and the knowledge-based economy***

The openness of the Belgian economy stimulates competition on the goods markets, leading to high labour productivity and consumer price levels in line with the EU average. The transposition rate of Internal Market directives met the March 2002 target of 98.5%. Despite a lack of effective competition on the local loop, the liberalisation process is progressing well in the telecommunications sector, and broadband access is diffusing fast, thanks to cheap access costs. However, the links between local public authorities and private partners still lack transparency, and liberalisation is less advanced in some service sectors such as energy. In particular, the delay in establishing the independent transmission system operator for electricity and the lack of regulatory approval of transmission tariffs has impeded market entry. As a result, competition remains limited in these sectors, leading to high prices. Whilst, on average, R&D and ICT expenditures are around EU standards, they remain concentrated in a few sectors and companies. Important reforms to reduce red tape and increase the efficiency of public services have been launched and have started to deliver results. However, the levels of administrative burden and State aid to railways remain high. In view of the above, the main priorities for Belgium should be to:

- i. increase competition in electricity and gas by officially designating an independent Transport System Operator with no significant involvement from incumbents (ownership unbundling), and by taking measures to encourage new retail suppliers by ensuring fair access to networks;
- ii. take measures to reduce the distortions of competition in the services sectors at local and provincial level which are due to the presence of public and mixed public-private enterprises; and
- iii. take further measures to reduce the administrative burden for businesses, including the time and cost required for registering a new company, and to develop e-government.

## 2. DENMARK

In 2001, economic growth decelerated to 0.9%, primarily due to a marked slowdown in investment growth and a deterioration of external demand growth. Output expansion is forecast to rise to some 1 ¾% this year and accelerate to around 2½% in 2003, mainly driven by domestic demand. In 2002, the factors sustaining growth should be private consumption, which is expected to rise in line with real take-home pay, and investment, which should recuperate with the expectations of a more favourable outlook. Danish exports are assumed to grow fairly in line with external demand, and with imports developing in line with final demand, the growth contribution of net exports is expected to be negative again this year. In 2003, domestic demand should strengthen further whereas net exports are assumed to give a fairly neutral contribution to growth. Inflation (HICP), which rose by 2.3% in 2001, is forecast to remain around this level also in the current year, as rises in the prices of clothing should compensate for the effects of somewhat lower oil prices and the “tax freeze” introduced by the new government, before falling slightly in 2003. The labour market will remain tight. Employment is expected to rise marginally in the current year and by close to ½ a per cent in 2003. Despite the slowdown in the economy, registered unemployment has remained at a very low level and a small decline in the unemployment rate is expected in 2003 as growth takes off.

The Danish economy, which currently operates at a level close to its potential, needs to enhance its production potential by focusing on the following key challenges: Easing labour supply constraints, which would also help holding back the sustained high pay rises. Competition in a number of important business sectors remains inadequate and, taking the size of the public sector into account, efficiency in this sector needs to be further improved. Furthermore, achieving effective restraint of government consumption remains essential, and this is even more compelling after the introduction of the “tax freeze” so that the general government finances can continue to run high surpluses also in the medium-term.

### ***Budgetary policy***

In 2001, the general government surplus was 2.8% of GDP, excluding the UMTS revenues of 0.2 percentage points. The budget surplus is expected to decline to 2.1% of GDP in the current year and thereafter to rise to 2.4% of GDP in 2003. The decline in the surplus in 2002 is primarily due to the fact that a proposed change of the Special Pension Savings Scheme has been incorporated for the forecast years, lowering the surplus by some ½ percentage points of GDP<sup>1</sup>. The latest update of the Danish convergence programme maintained the strategy of slowly declining ratios of primary expenditure and taxes to GDP. As often in the past, the real increase in government consumption in 2001 exceeded the target set by the previous government. A novel element is that the new government, which took office in November 2001, has committed itself not to raise any direct or indirect tax rates. In addition, a ceiling on the nominal property value tax has been imposed. No expiry date has been set for this “tax freeze”. Long-term projections in the updated programme suggest that general

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<sup>1</sup> The new government has proposed that the Special Pension Savings Scheme (SP) should be transformed from a redistributive tax scheme to a compulsory, individual pension scheme effective as of 2001. The proposal has the majority needed in the Parliament. The change will lower the level of the general government surplus by approximately ½ percentage points of GDP from 2002 onwards because these savings, following the change, will be considered as private rather than public savings in the national accounts. This is in line with the deficit and debt reporting of 28 February 2002.

government finances have to run annual surpluses of 1 ½ - 2 ½% of GDP up to the year 2010 in order to cope with the financial impact of the ageing population. In view of the above, budgetary policy should aim to:

- i. ensure that the government's target of restraining real growth in government consumption to 1 per cent a year on average is reached, implying that the increase in 2003 preferably should not exceed the authorities' forecast of 0.7% in order to offset the rise of 1.3% included in the budget for 2002; and
- ii. secure implementation of the tax freeze by all levels of government, possibly by binding commitments from the part of counties and municipalities in the agreements related to the budget for 2003.

### ***Labour markets***

The Danish employment performance is the best among EU countries, with employment rates in 2001 of 76% overall, 72% for women and 56% for older workers. The unemployment rate continued to fall slightly in 2001, reaching 4.3%, and the labour market situation remained tight. No new reform efforts were undertaken in 2001. However, the previous reforms continue to reduce inflows to the early retirement and disability pension schemes and marginal tax rate reductions are due to take place in 2002 in accordance with the 1999 Whitsun package. The new government has recently announced a tax-freeze. Despite previous reforms, there has been a clear trend towards negotiating shorter working hours and withdrawal from the labour market is relatively high. The share of working-age people in benefit schemes (including unemployment benefits) and active labour market programmes is 21%, which in part contributes to persistent labour supply constraints. A further expansion in labour supply, which is necessary in light of the ageing of the population, could be encouraged via tax and benefit reforms, to make the underlying tax-benefit structure more favourable for employment. In view of the above, while vigorously implementing all the Employment Recommendations adopted by the Council in February 2002, the main priority for Denmark should be to:

- i. make work pay by continuing the reforms of transfer systems and by reducing further the fiscal pressure on labour, especially on low and medium wage earners.

### ***Product markets, entrepreneurship and the knowledge-based economy***

The Danish economy is less open (as measured by total trade-to-GDP ratio) than most other small Member States and has a relatively high price level, which is partly due to a lack of competition in a number of sectors. Ad hoc and sectoral State aid is low and the record in transposing Internal Market directives is excellent. Progress has been made in liberalising telecommunication and electricity markets as well as in opening up public procurement. There has been less success in opening up gas markets to competition. ICT penetration is high and R&D expenditures are above the EU average. However, in the field of R&D, Denmark performs less well than the other Nordic Member States, in part owing to lower business R&D spending and a poorer commercialisation record. In addition, according to an OECD survey, Denmark combines a high level of public education expenditure with relatively low education results. In view of the above, the main priorities for Denmark should be to:

- i. step up efforts to enforce competition in those sectors where competition has been found to be inadequate;

- ii. enhance competition in public service provision at the local level via increased participation of the private sector and competition between public service operators; and
- iii. complete full market opening of electricity and gas markets and ensure fair network access.

### **3. GERMANY**

In 2001, German GDP increased by 0.6%. Regarding private consumption, the income tax reductions implemented in January of the year limited the decline in the growth rate triggered by the hike in fuel prices and unemployment, which started to rise during the year. By contrast, investment fell strongly in an environment of low growth expectations. A further drag on the economy was the substantial depletion of inventories. As a result domestic demand remained flat in 2001. Growth therefore came essentially from net exports, mostly due to stagnant import volumes. For 2002, leading indicators point to a recovery by the middle of the year. Driving force should be a pick up in investment, while consumption is likely to remain sluggish as a result of rising unemployment. Despite the expected strong upswing, however, annual average GDP growth in 2002 will remain below 1% due to the strong negative statistical overhang at the beginning of the year. On the back of higher than assumed oil and food prices the average rise in consumer prices in 2001 reached 2.4%. The expected reversal of these price effects should lower price pressures and keep CPI inflation below 2%, at one of the lowest levels in the euro area. Employment started to decline in 2001 and will, in spite of the expected acceleration of economic activity, on average be lower in 2002. As a consequence, unemployment should be higher in 2002 on average than in 2001.

As a result of the economic downswing, the government deficit in Germany rose to 2.7 % of GDP in 2001. A key challenge is, therefore, to accelerate the consolidation of public finances and to ensure a strict implementation of the stability programme, in particular with a view to keeping the 2002 government deficit below the Treaty's 3% of GDP reference value. While the present cyclical downturn as such is mainly externally induced, the growth potential of the German economy is held back by lagged effects from re-unification, including the crisis in the construction sector, and by slow progress in structural reform, particularly in the labour market. Highest priority should therefore be given to reforms aimed at reducing the persistently high unemployment rate and regional unemployment disparities and at improving efficiency of active labour market policies. This should be supported by policies to increase the employment rate, notably by reforming the benefit schemes in order to make work pay and by tackling the disincentives to labour market participation, especially of women. Improvements in the overall business environment, particularly by further product, capital and labour market reform, should also contribute to strengthening Germany's economic growth potential.

#### ***Budgetary policy***

According to the most recent estimate by the Federal Statistical Office, the 2001 general government deficit reached 2.7% of GDP. This deterioration compared to the outcome for 2000 (-1.3% of GDP excluding UMTS proceeds) and to the projections of the October 2000 update of the German Stability Programme (a projected 2001 deficit of 1½% of GDP) is essentially due to the stronger than anticipated growth slowdown and some statistical revisions. Expenditure overruns, however, were registered in the health care sector and in some Länder. In the current year, low GDP growth and the rise in some benefits should imply that the deficit will not decline compared to last year, in spite of the hike in some taxes.

In the Ecofin Council meeting of 12 February 2002, the German government committed itself to respect the 3% of GDP reference value for the general government deficit in 2002 and confirmed its commitment to reach a close to balance budgetary position in 2004. This was reaffirmed by the agreement reached between Bund and Länder in the special session of the Financial Planning Council

(Finanzplanungsrat) on 21 March 2002. In view of the above, and considering that Germany is a member of the euro area, budgetary policy should aim to:

- i. ensure that the 3% of GDP reference value for the general government deficit will not be breached. Use any potential growth dividend to reduce the 2002 deficit below the 2 ½% of GDP targeted in the last updated Stability Programme;
- ii. aim at a sufficient decline of the 2003 deficit to ensure that a close to balance position in 2004 can be achieved. To this end ensure that the budgeted 2003 rise in expenditure at all levels of government and in the social security systems remains close to zero and that any potential growth dividend be used to reduce the deficit;
- iii. implement the necessary reform of the health care system in order to reduce expenditure pressures and to contribute to improving the quality and sustainability of public finances; and
- iv. adopt in the current parliamentary term the agreed changes to the Haushaltsgrundsätzegesetz and enable an effective control of the agreements reached in the special session of the Finanzplanungsrat of 21 March 2002.

### ***Labour markets***

The German labour market suffered from the economic downturn in 2001, when employment growth came to a halt and unemployment started to rise again. The overall employment rate is, at 65% in 2000, above the average of the European Union. Youth unemployment is relatively low. However, unemployment, half of which is long-term unemployment, remains high, at 7.9% slightly above the EU average. Regional unemployment rates continue to vary sharply. Despite of a recent flexibilisation of wage bargaining, wage differentiation and mobility are not sufficient to contribute adequately to a marked reduction of the regional differential. Positive steps have been taken through new legislation aimed at rationalising active labour market policies (ALMPs), but the efficiency of large-scale active programmes in high-unemployment regions must continue to be improved. Moreover, the labour market activity of low skilled workers is very low and their unemployment risk is 60 percent higher than that of the average worker. Further increases of the employment rate will critically depend on overcoming still strong disincentives and barriers with respect to labour market activity of low skilled workers, older workers and women. In view of the above, while vigorously implementing all the Employment Recommendations adopted by the Council in February 2002, the main priorities for Germany should be to:

- i. intensify efforts to make work pay via tax and benefit reform, in particular for women and older workers. Candidates for benefit reform are: benefit eligibility, conditionality, duration and replacement rates as well as benefit withdrawal when taking up work. Social security contributions should be reduced, in particular at the low end of the wage scale, while complying with the need for sound public finances;
- ii. improve the efficiency of ALMPs, in particular where they are used on a large scale, and further develop job-search assistance while improving its efficiency. Improve the targeting of ALMPs towards those groups most prone to the risk of long-term unemployment, as well as to meet the demands of the labour market;



- iii. promote labour institutions and collective bargaining systems, respecting the autonomy of social partners, that take into account the relationship between wage developments and labour market conditions, thereby allowing an evolution of wages according to productivity developments and skills differentials, in order to improve employment across skills and geographical areas, while preserving stability- and employment-oriented wage developments;
- iv. take measures to make work contracts and work organisation more flexible with a view to striking a proper balance between flexibility and security; and
- v. remove barriers to female labour market participation, inter alia by promoting the availability of childcare facilities.

### ***Product markets, entrepreneurship and the knowledge-based economy***

The German economy is relatively open for a large-sized economy (as measured by the total trade-to-GDP ratio) and consumer price levels are close to the EU average. State aid is declining gradually. Time and cost requirements for the start-up of a private limited company are around the EU average and only minimal for sole traders. Germany has a strong position in the knowledge-based economy as measured by business expenditures on R&D, patent applications, and the share of the labour force with at least upper secondary education. Progress on Internal-Market related issues (transposition of Internal Market directives, opening up of public procurement) has been limited. Price levels for electricity (households) and gas remain well above the EU average and former regional monopolists continue to benefit from the system of negotiated third-party access. Finally, the educational achievements of 15-year-olds and the share of high school students that go on to university are below the EU average. Two thirds of the age group concerned start a qualified dual vocational training programme. In view of the above, the main priorities for Germany should be to:

- i. ensure effective competition on electricity and gas markets leading to a reduction of the levels of and regional differences in the fees charged for the use of energy distribution networks; establish a regulatory function for energy with a view to ensuring effective control of the tariff-setting conditions;
- ii. reform the primary and secondary education system in order to improve students' educational achievements in general and especially to raise the share of school leavers that go on to university; and
- iii. raise the transposition rate of Internal Market legislation with the aim of achieving the target of 98.5% of Internal Market directives, and raise the value of public tenders published in the Official Journal.

## 4. GREECE

In 2001, following the deterioration in the global economy, economic activity decelerated somewhat but was supported by domestic factors. Considerably lower interest rates, following euro area membership as from 2001, and increasing inflows of financial resources from the EU Structural Funds, combined with the preparation for the Olympic Games of 2004, sustained investment. At the same time, a sharp increase in consumer credit and recovery in real disposable income, boosted consumer spending. Nonetheless, external trade had a negative effect on real GDP growth, reflecting both the high import content of domestic demand and limited improvement in competitiveness. Such a pattern of growth is expected to persist in 2002, while an improvement is forecast for 2003 as a result of resuming external demand. The situation in the labour market improved at a slow pace in the latest years, employment rising at relatively low rates in the whole economy despite strong job creation in the services and the construction sector. Inflation pressures in early 2001, resulting from second round effects of the oil prices hike in 2000, started to ease in the second half of 2001; but, uncertainties still remain, related to the outcome of the ongoing negotiations on the private sector wage agreement.

Despite progress made in recent years, medium-term challenges require further improvement in the functioning of the Greek economy. Fiscal imbalances were corrected in recent years, but the government debt ratio remains at a very high level and requires further robust budgetary adjustment, particularly taking account of the serious risk that budgetary imbalances might emerge in the future due to ageing populations. The current real GDP growth phase provides an opportunity to accelerate structural reform aimed at increasing the still low level of productivity, at improving the efficiency of the labour and product markets and at creating a better environment for business. Finally, tackling the high rate of structural unemployment and increasing employment rates remains a key challenge.

### *Budgetary policy*

In 2001, the general government account achieved a deficit of 0.4% of GDP and a balance when including non-budgeted UMTS receipt. The 2001 update of the stability programme projects the government surplus at 0.8% of GDP in 2002 and 1% of GDP in 2003; these budgetary projections are based on high real GDP growth for the period reaching around 4% per year. The budgetary strategy continues to be centred on the achievement of high government primary surpluses which, nonetheless, are expected to decline over the period; in fact, the improvement in the government balances fully results from a steady decrease in interest payments while, in contrast, little retrenchment in current primary expenditure is expected. The government debt ratio is forecast to decline from 99.6% of GDP in 2001 to 94.4% of GDP in 2003, a reduction limited by autonomous factors, namely large financial operations. In view of the above and considering that Greece is a member of the Euro area, budgetary policy should aim to:

- i. ensure that the budgetary stance in 2002 and 2003 does not contribute to inflationary pressures, also taking into account the outcome of the forthcoming 2002 national wage agreement in the private sector;
- ii. comply with the guideline already issued in the 2000 BEPG asking for the application of clearly defined and binding norms for current expenditure increase in real terms;
- iii. ensure that the government debt to GDP ratio declines in line with the projected reduction in the government deficit as well as with the increase in nominal GDP and limit the use of financial operations influencing negatively the level of the government debt; and

- iv. accelerate the reform of the social security systems and in particular proceed to the reform of the pension system from 2002 in order to avoid serious budgetary imbalances which might emerge in future years from the ageing populations.

### ***Labour markets***

The economic upturn in recent years in Greece has been accompanied by employment growth (although at rates below the euro-area average). While this employment creation was initially outstripped by increases in labour supply, in the last one or two years job growth has led to a slight fall in the unemployment rate, notably in 2000. Nevertheless, the Greek labour market is still characterised by a low employment rate (55.7% in 2000) and a high level of structural unemployment. Moreover, the labour market is highly segmented with high rates of youth and female unemployment, and a high share of long-term unemployment. Labour market policy measures in 2001 focused on the implementation of the December 2000 package of labour market reforms, and the on-going reforms in the Public Employment Service and the educational and vocational training system. Despite recent measures, the labour market still displays a number of problems including: heavy labour market regulation; insufficient wage differentiation; and distortions to incentives to work in the formal sector embedded in pension entitlements and in the tax system. The latter include a strong degree of progressivity of personal income taxes and a high burden on dependent employees compared with the self-employed, even though the average tax burden is low. Moreover, the educational and vocational training system should be further strengthened to better meet the requirements of the labour market. In view of the above, while vigorously implementing all the Employment Recommendations adopted by the Council in February 2002, the main priorities for Greece should be to:

- i. urgently pursue reform of pensions entitlements in order to encourage older workers to take up and remain in work;
- ii. continue to improve educational and vocational training systems in order to enhance the skills of the labour force and meet the needs of the labour market;
- iii. continue progress in eliminating the major distortions to work incentives arising from labour taxes;
- iv. promote changes to the wage formation system in order to ensure that wages better take into account differences in productivity levels and local labour market conditions. In particular, the opt-outs included in the territorial employment pacts should be made a practical possibility; and
- v. fully implement labour market reform packages, and monitor their impact on labour market performance in order to ensure that positive effects are maximised. In particular, further build upon these efforts by loosening restrictive employment protection legislation, with a view to ensuring a proper balance between flexibility and security, and by speeding up the restructuring of the Public Employment Service.

### ***Product markets, entrepreneurship and the knowledge-based economy***

Partly due to its geographical location the Greek economy is less open than any other Member State (as measured by the total trade-to-GDP ratio). The effective enforcement of competition policy rules is thus very important to guarantee high levels of competition in domestic product markets and stimulate productivity gains. Indeed, the level of labour productivity, while rising strongly in recent years, remains the second lowest in the EU. The Internal Market transposition deficit was more than halved but the transposition rate remains below the March 2002 target of 98.5%. While efforts are underway to improve the business environment and enhance the performance of the public administration, the costs to set up a new company remain high and the system of company taxation is quite complex and possibly constrains firms' incentives to grow. Also because liberalisation has happened only recently, the market position of incumbents in network industries remains strong. The low levels of average educational attainment of the population remain a concern, and are among the factors responsible for the overall still low –albeit growing– level of ICT diffusion in Greece (broadband penetration is the lowest in the EU) and the very weak R&D and innovation performance. In view of the above, the main priorities for Greece should be:

- i. step up efforts to increase the availability of skilled human capital, promote business involvement in R&D and innovation and continue to improve ICT diffusion;
- ii. continue to streamline administrative rules and procedures, to increase the efficiency of the public administration and make the system of company taxation neutral as to the form of business organisation;
- iii. enhance effective competition in liberalised network industries, in particular for the provision of electricity and sea transport services; and
- iv. sustain the progress made in raising the transposition rate of Internal Market legislation with the aim of achieving the target of 98.5% of Internal Market directives.

## 5. SPAIN

After having grown by around 4% in 1999 and 2000, output growth weakened significantly in 2001 due to a more moderate domestic demand, in particular a fall sharp of investment in equipment, and a gradual slowdown of exports during the year. In 2002, heavily influenced by the slowdown registered in the second half of the previous year, GDP growth is expected to decelerate further on average but with a recovery gaining strength through the year. This recovery should stem from both a gradual improvement in domestic demand components and renewed dynamism of exports. In 2003, along with better international prospects and underpinned by a recovery of domestic expenditure, GDP should grow in line with estimated potential. Based on this macroeconomic scenario, employment growth should slow down in 2002 and recover strength next year implying a decreasing unemployment rate to around 12% in 2003. Inflation is expected to fall to around 2.5% on average in 2002 compared to 3.6% in the previous year. This easing of inflationary pressures would be supported by the national wage agreement signed last year to preserve wage moderation and by moderate import prices. In 2003, inflation could further decelerate to close to 2.0% on average.

Although Spain made progress in implementing the recommendations of the 2001 BEPGs and prospects for the Spanish economy are positive, some problems remain unsolved. In particular the long-term sustainability of public finances need to be addressed through a comprehensive reform of the pension system since the April 2001 agreement between the government and the social partners did not represent a significant step to tackle the underlying imbalances. In turn, the unemployment rate, although more than 10 percentage points below its 1994 peak, remains high in comparison to other EU countries, along with wide disparities among regions and poor employment rates especially for women. Finally, in spite of the easing of inflationary pressures, underlying inflation continues to post relatively high growth rates while apparent productivity growth remains sluggish. This performance may be indicative of an insufficient degree of competition in some sectors and a lag in the development of the knowledge-based economy.

### ***Budgetary policy***

Despite weakening growth the fiscal consolidation process continued in 2001, when the general government sector was for the first time in balance down from a 0.3% deficit recorded in 2000. According to the 2002-2005 updated stability programme, the general government sector is expected to maintain a balanced budget in 2003 and reach a small surplus of 0.2% of GDP in 2005. The fiscal strategy outlined in the update remains unchanged compared to the previous programmes. It is based on a restraint of primary current expenditure, supported by decreasing interest payments, which allows for an increase in capital expenditure. In turn, the programme envisages a new reform of personal income tax to take effect from 2003 consistent with the maintenance of fiscal consolidation. The programme incorporates the new financial system for territorial governments, which has involved the decentralisation of tax and spending powers. In parallel with the start of this new system, the Law of Budgetary Stability, aiming at ensuring the commitment of all general government sub-sectors to the respect of the close-to-balance objective, was approved. The 2002-2005 update does not provide appropriate measures to deal with ageing population. This is of concern, given Spain's particularly exposed demographic profile and the implied adverse budgetary consequences of ageing. The announced intention of pursuing the reform of the pension system lacks a detailed calendar. In the recent past, the main measure adopted to deal with ageing remains the social security fund created in 2000 to finance future liabilities, assets of which were planned to reach 1% of GDP in 2004 according

to the latest stability programme. However, in early April the Spanish authorities announced that this target would be reached in 2002. All in all, and considering that Spain is a member of the euro area, budgetary policy in Spain should aim to:

- i. ensure restraint of primary current expenditure as planned, so as to maintain the balanced budget position in accordance with the updated stability programme;
- ii. ensure that the reform of personal income tax to be legislated in 2002 enhances incentives to work and save, and does not put at risk medium-term stability objectives; and
- iii. review the public pension system in a comprehensive way so as to promote its long-term viability. Give priority to the use of the surpluses registered in the social security sub-sector to further increase the pension reserve fund.

### ***Labour markets***

A marked improvement in labour market performance over the past few years means Spain is catching up rapidly with other EU Member States in terms of employment rates. The overall employment rate rose from 52.3% in 1999 to 54.7% in 2000. The female employment rate rose by three percentage points to 40.3%. Unemployment has continued to fall, to 12.8% in December 2001, though this is still the highest in the EU, and female unemployment remains double the rate for males. Regional unemployment disparities remain severe, with unemployment rates on the mainland ranging from 6.3% to 22.3% (Q4 2001). Key structural problems include the failure of labour costs to adjust to productivity and local labour market conditions, and low labour mobility, partly owing to housing market rigidities and the operation of certain regional benefit schemes. The reforms of March 2001 appear to go some way towards addressing rigidities in the area of employment contracts. There remains further scope for increasing overall investment in training and for measures to ensure the efficiency of active labour market policies. Further efforts to encourage increased labour market participation will be needed in order to sustain the impressive performance of recent years. In view of the above, while vigorously implementing all the Employment Recommendations adopted by the Council in February 2002, the main priorities for Spain should be to:

- i. take further steps towards the reform of wage formation so that wages take better account of regional differences and evolve according to productivity developments and skills differentials;
- ii. diminish obstacles to labour mobility, inter alia, through improvements to the functioning of the housing market and reform of regional benefit schemes and encourage conditions conducive to employment creation in regions lagging behind;
- iii. ensure that active labour market measures are efficient and tailored to the needs of those most prone to the risk of long-term unemployment or those with lower participation rates (in particular women) and to the demands of the labour market;
- iv. take further steps to encourage increased labour force participation, especially among women, and adopt targets for the adequate provision of facilities for care of children and other dependants; and

- v. ensure a proper balance between flexibility and security by means of the recent employment contract reforms, and further steps if necessary, with a view to early progress in terms of a reduced share of fixed-term contracts and greater use of the part-time contract.

### ***Product markets, entrepreneurship and the knowledge-based economy***

The openness of the Spanish economy has continually increased in recent years. The record in transposing Internal Market legislation is among the best in the EU. However, the slowdown of productivity growth is perceived as a problem for the Spanish catching-up economy. The implementation of the ambitious liberalisation plan launched by the government in June 2000 continued in 2001, but the market share of incumbents in fixed telecommunication and gas remain high and the wholesale market for electricity continues to suffer from a lack of competition. In addition, some non-tradable sectors such as pharmacies, hyper-markets and books, still have sector-specific regulations with restrictive effects on competition. Initiatives to increase ICT users and to foster R&D were adopted by the government and the results are expected soon. The low public and business expenditure on R&D, together with relatively few patent applications, remain major weaknesses relative to other Member States. Public expenditure on education is below the EU average and educational attainment is low. Finally, the regulatory framework for SMEs remains relatively complex, which can contribute to the long time and high cost involved in creating a new company. In view of the above, the main priorities for Spain should be to:

- i. continue policies aimed at guaranteeing a level playing field for operators in the telecommunications and energy sectors, at reducing the market share of the incumbents in order to enhance effective competition in those sectors, and at encouraging market entry in the wholesale market for electricity;
- ii. continue to take measures to enforce effective competition in retail distribution, including pharmacies, hyper-markets and books;
- iii. step up efforts to increase skilled human capital, business involvement in R&D and innovation, and ICT diffusion; and
- iv. pursue the strategy to reduce the administrative burden for businesses, including the time and cost required for registering a new company.

## 6. FRANCE

After three years of robust growth, resulting in strong employment creation, economic activity slowed markedly from the beginning of 2001, reflecting the impact of the deterioration in the global economy. The sharp deceleration in exports entailed adjustment in stocks and investment projects were postponed. Conversely, private consumption, which benefited from a robust growth in disposable income and a resilient labour market, remained dynamic, allowing the economy to avoid a more severe slowdown. Prospects for 2002 and 2003 are more favourable; as the economy is not burdened by any important imbalance, improving confidence and accelerating external demand should lead to a rebound in GDP growth in the course of 2002. The slight deterioration in the situation in the labour market observed since May 2001 should come to an end in the course of 2002 and the unemployment rate is expected to recover a downward path. This should not alter significantly the behaviour of wages, which are projected to grow moderately. Finally, inflation should remain clearly below 2% in the next two years, at one of the lowest level in the euro area.

When compared to other countries of the euro area, the French economy showed a relatively strong resilience to the recent shock on external demand. This can be partly attributed to the strength of the labour market and to lower inflation, together with positive effects of formerly planned tax cuts. However, some further progress remains to be made. On the labour market, increasing labour market participation and reducing the high rate of structural unemployment remains a key challenge. Moreover, health and pension reform should be tackled, with a view to ensuring the sustainability of public finances. Efforts should be made to secure the control of public expenditure, in particular in the health sector. Finally, in order to enhance the medium-term performance of the economy, liberalisation of network industries and adoption of Internal Market rules should be accelerated.

### *Budgetary policy*

In 2001, the general government deficit is estimated to have increased to 1.5% of GDP (1.4% including UMTS revenues), as against 1.3% in 2000. The non-achievement of the deficit target fixed in the 2001 Finance Law, 1% of GDP, is to be attributed partly to cyclical conditions, which reduced tax revenues, and partly to higher-than-planned increase in nominal expenditures. Under current macroeconomic assumptions, taking into account the implementation of tax cuts and the planned increase in real expenditures, the general government deficit should reach 1.9% of GDP in 2002 before decreasing only slightly in 2003. The 2001 updated stability programme targets a balanced general government position for 2004 or 2005. In its Opinion of 12 February 2002 on the updated stability programme of France (2003-2005), the Council urged the French authorities to use every opportunity to reach a balanced position in 2004. Achieving the budgetary objectives of the 2001 updated stability programme is a necessary step in view of medium term challenges for the general government finances stemming from ageing of population. In view of the above, and considering that France is a member of the euro area, budgetary policy should aim to:

- i. ensure that the government deficit in 2002 will remain below 2% of GDP, limiting the increase in general government expenditure in real terms to 2.2% as projected in the 2001 updated stability programme;
- ii. in order to reach a balanced position in 2004 use every opportunity to reduce the general government deficit in 2003, in particular through increased restraint in real government expenditure; and



- iii. define without delay a comprehensive reform of the pension system allowing to secure a sustainable evolution for public finances in the context of ageing populations.

### ***Labour markets***

After a number of impressive years, in line with a slowdown in economic activity, employment growth slowed and the trend of gradual decline in the unemployment rate was halted. Despite the good performance of previous years, the employment rate in France remains relatively low (62.0% in 2000), and that of older workers very low. The unemployment rate is still high, with high rates of youth unemployment, despite large-scale public youth job creation schemes. Policy measures in 2001 included: the continued implementation of the 35 hour working week legislation, notably to the transition period for small- and medium-sized firms (SMEs); the introduction of a new support scheme to help the unemployed with job search (the PARE); the continued phased introduction of the earned income tax credit; and finally the adoption of a new law on social modernisation which strengthened employment protection legislation. Moreover, publicly subsidised job creation schemes have represented a substantial share of net job creation in recent years. However, despite recent measures, there still remain problems of disincentives emerging from the tax and benefit system, particularly for low-paid and older workers. The transition to a shorter working week could also prove more problematic in SMEs despite measures to allow a more relaxed implementation in these firms. In addition, the protracted phased implementation of the shorter working week has led to the existence of several wage minima, some of which have been rising quickly due to the interaction of the indexation mechanism for hourly minima with automatic increases in hourly wages. Finally, it is unclear what impact the further recent strengthening of employment protection legislation will have on labour market dynamics. In view of the above, while vigorously implementing all the Employment Recommendations adopted by the Council in February 2002, the main priorities for France should be to:

- i. consolidate recent reforms of the tax and benefit system to improve the incentives to take up and stay in work, and to encourage job-search. Firstly, incentives for older workers to remain in jobs should be strengthened, in particular by reducing the opportunities for early retirement, and by reforming the overall pension system. Secondly, focus should be paid to low-paid workers, disincentives to part-time work, and minimum income guarantee schemes;
- ii. closely monitor the implementation of the 35-hour working week, and take measures necessary to address any adverse medium-term effects on wage costs and labour supply, while encouraging the full exploitation of opportunities for more flexible work organisation; and
- iii. reform employment protection legislation with a view to striking a proper balance between greater flexibility and security to facilitate access to employment. Avoid any negative effects on labour market dynamics of the recent changes to employment regulations.

### ***Product markets, entrepreneurship and the knowledge-based economy***

The French economy is open to international competition and is well integrated into European markets. Labour productivity is relatively high and the price level has fallen towards the European average. Progress has been made in transposing Internal Market directives in the last two years and ad hoc State aid has been reduced markedly. However, the gas and electricity markets are being liberalised at a slow pace and France's record in transposing the Internal Market directives is still

considerably below the March 2002 target of 98.5%. Moreover, despite some improvements, the administrative burden on business remains among the highest in the EU. Finally, although measures have been taken to encourage the development of a knowledge-based society, France still lags behind most other Member States especially in the use of the Internet. In view of the above, the main priorities for France should be to:

- i. speed up the liberalisation of the gas and electricity sectors by implementing the current Gas Directive without delay, by opening up markets for non-household consumers to competition and by taking measures aiming at reducing the market share of incumbents in order to foster effective competition;
- ii. raise the transposition rate of Internal Market directives with the aim of achieving the target of 98.5% of Internal Market directives;
- iii. continue ongoing efforts made to reduce the administrative burden on business, especially by lowering the time required for registering a new private limited company; and
- iv. take measures to further facilitate access to the internet among households, small businesses and schools.

## 7. IRELAND

After average growth of 9.9% in the period 1996-2000, the Irish economy experienced a sharp slowdown in the course of 2001. The weakening of activity was due to the interplay of capacity constraints, foot-and-mouth disease precautions and the downturns of the international economy in general and the ICT sector in particular, to which Ireland is more heavily exposed than other EU countries. Confidence indicators and the purchasing managers' index suggest that a rebound from a late-2001 trough is underway, with a strong recovery expected from about mid-2002. By 2003, the economy should have reverted to a growth rate that is sustainable in the medium term, of about 5 to 6 percent. While the labour market proved to be remarkably resilient in 2001, a further increase in unemployment seems inevitable in 2002, to some 4½ percent. Nonetheless, the labour market is expected to remain quite tight. As a result, some drift above the wage provisions in the national agreement is to be expected and domestically-generated inflationary pressures are unlikely to abate. Due to various indirect tax rate increases, average inflation in 2002 will probably be higher than the 4.0 percent recorded for 2001, although the general trend from the first quarter of 2002 should be downwards.

Social partnership has been a cornerstone of Irish economic policy since 1987. The current three-year agreement, which expires end-2002, provided for increases in after-tax income of 25 per cent or more, to be reached through a combination of nominal wage increases and direct tax relief. A key challenge is to adapt the current wage setting process and the tax and spending commitments in national agreements to the new environment characterised by conditions approaching full employment and more limited budgetary resources. Growth in discretionary ("voted") spending has been in double-digits in recent years, which is not sustainable in the medium-term. Developing the necessary policies to guide public spending in line with resources in the medium term and improving expenditure control should be seen as another key challenge. While Ireland has taken measures to increase competition in some markets, there remains an insufficient degree of competition in some sectors. For example, in the areas of professional services, retail distribution and network industries, there is scope for strengthening competition.

### ***Budgetary policy***

In 2001, a large tax shortfall led to a general government surplus of 1.7 percent of GDP, some 2½ percentage points below target. This is the lowest surplus since 1997. The stability programme 2002-2004 targets a small surplus for 2002 and envisages a return to a (small) deficit for 2003-2004. However, in the event that the large contingency provisions against unforeseen developments incorporated in the 2003-2004 targets are not used, a small surplus would be recorded in each year and the close-to-balance requirement of the Stability and Growth Pact would be broadly respected. Regarding debt developments, the stability programme projects a near-stabilisation of the debt ratio at the low level of 34% of GDP. In view of the above, and considering that Ireland is a member of the euro area, budgetary policy should aim to:

- i. ensure that the budgetary stance for 2002 is broadly neutral;
- ii. ensure continued compliance with the close-to-balance requirement of the Stability and Growth Pact after 2002; and
- iii. improve expenditure control and develop, for use in the 2003 budget round and beyond, a norm-based framework to guide public spending in the medium-term.

### ***Labour markets***

Employment growth held up well during 2001, despite the economic slowdown, with employment gains moderating but still averaging some 3% for the year. The overall employment rate exceeds the EU average and female employment growth continues to outpace that for males but there still remains scope for further increases in the female employment rate. Unemployment rose slightly during the second half of 2001 but the rate still remained close to 4% at year end. While this rate is likely to rise somewhat in 2002, conditions approaching full employment are expected to continue. The available evidence indicates that earnings growth remains fairly high, exceeding the 7½% pay increase for 2001 provided under the national agreement. The challenges of a tight labour market remain in relation to mobilising labour and future wage setting processes. In view of the above, while vigorously implementing all the Employment Recommendations adopted by the Council in February 2002, the main priorities for Ireland should be to:

- i. promote the setting of wages in line with productivity developments and skills differentials and consistent with the maintenance of competitiveness and price stability; and
- ii. continue to focus measures on increasing the participation of women in the labour market.

### ***Product markets, entrepreneurship and the knowledge-based economy***

Ireland is highly exposed to international competition and labour productivity is well above the EU average. Ireland's price level was 5% above the EU average in 2000 and has been rising relative to the EU average in recent years. The liberalisation of the network industries is continuing, although State-owned incumbents still have high market shares in these sectors. Whilst regulations affect the level of competition in certain service sectors such as the professions and retail distribution the overall regulatory burden on business is low. In March 2002 the rate of transposition of Internal Market directives (97.9%) remained below the target of 98.5%. Sectoral and ad hoc State aid is low although total State aid (as a % of GDP) is at the top end of the range in the EU. Ireland's ICT production (as a % of total production) is the highest in the EU, partly due to the presence of a large number of foreign-owned high-tech firms. However, R&D expenditure is below the EU average, particularly public R&D, which is being addressed by recent measures. In view of the above, the main priorities for Ireland should be to:

- i. implement measures to increase effective competition in the local telecommunications, electricity, gas and transport sectors in particular to address the high market share of State-owned and private incumbents;
- ii. address government regulation, which may impair competition in certain market sectors such as the professions and retail distribution; and
- iii. raise the transposition rate of Internal Market legislation with the aim of achieving the target of 98.5% of Internal Market directives.

## **8. ITALY**

In 2001 real GDP growth slowed to 1.8%, prompted by a declining external contribution and, subsequently, by weakening domestic demand. After passing the trough in November, economic activity is expected to pick up gradually at the beginning of 2002 on account of the improving global outlook and recovering confidence. The upturn is likely to become steeper around mid year. Investment expenditure, in particular, is forecast to accelerate in view of a temporary tax incentive scheme due to expire at the end of the year. Owing to the low starting point inherited from 2001, real GDP growth will remain well below 2% in 2002 and is expected to rise to around 2 3/4 % in 2003. Employment growth is likely to weaken in 2002, on account of the lag with respect to output. The performance of the labour market is forecast to improve again in 2003, with the rate of unemployment likely to fall below 9%. With no significant pressure from import prices and wages and a still negative output gap up until the end of the year, inflation is expected to ease in 2002. However, due to the consecutive hikes in January and February, resulting from temporary effects, annual average inflation is unlikely to fall below 2%. It is forecast to stay above that threshold in 2003, upheld by rising demand pressure.

In the coming years fiscal policy aims at simultaneously achieving a significant reduction in the tax burden while respecting the medium-term objective of a budget in balance or in surplus. Hence, improving the control and quality of government expenditure remains of paramount importance. Although narrowing somewhat in 2001, the wide unemployment gap between the North and the South continues to be the overriding regional and labour market issue. Linked to that are the restrictive employment protection legislation and the underdeveloped unemployment safety net. To support the goal of rising the underlying speed limit of the economy to around 3% per year, economic policy needs to address the low employment rates as well as to accelerate the thus-far slow transition to the knowledge-based society in terms of educational attainments, skilled human resources and R&D performance. In the same policy context, it is necessary to improve the business environment and to enhance competition in the product markets.

### ***Budgetary policy***

The general government deficit to GDP ratio in the year 2000, previously estimated at 1.5% of GDP (0.3% of GDP including receipts from the sale of UMTS licences), was revised to 1.7% of GDP (0.5% including UMTS receipts). Mostly as a consequence of this revision, the general government turnout in 2001 was a deficit of 1.4% of GDP, against a government projection of 1.1% of GDP. The 2001 public accounts benefited from one-off operations amounting to some 0.6% of GDP (sales of public real estate assets of 0.4% of GDP, largely through a securitisation process, and 0.2% of GDP from the securitisation of future net proceeds from the state lottery). Primary current expenditure was broadly stable at 37.5% of GDP, after decreasing by 0.3 points of GDP between 1999 and 2000. The cyclically adjusted deficit, according to Commission calculations, improved slightly compared to 2000, but the underlying budgetary position does not improve if the one-off operations are netted out in both years. The debt ratio decreased by 1.2 percentage points of GDP to 109.4%, a marked slowdown in the process of continued reduction. Market-related difficulties in meeting the privatisation objectives and lower-than-expected growth mainly contributed to this slowdown. The November 2001 update of the stability programme targets a sizeable reduction in the deficit ratio to 0.5% of GDP in 2002 and a balanced budget in 2003, while the debt ratio is to fall below 100 per cent of GDP by 2004. The Italian authorities face the challenge of securing additional and lasting reductions in the primary expenditure

to GDP ratio, improving the quality of expenditure, reducing the tax burden while achieving and maintaining the close-to-balance budgetary objective required by the Stability and Growth Pact. In view of the above, and considering that Italy is a member of the euro area, budgetary policy should aim to:

- i. ensure in 2002 and 2003 the respect of a steady path of deficit reduction, in order to achieve the objective of a balanced budget in 2003, by securing primary surpluses at the high levels projected in the updated stability programme, notably thanks to improved control of expenditures;
- ii. ensure that the timing and the scope of the reform of taxation, outlined in the enabling act presented to Parliament and aimed at reducing the tax burden, simplifying taxation and narrowing the tax wedge, are consistent with the achievement and maintenance of a budgetary position close to balance or in surplus; and
- iii. ensure that the changes to the social security system, for which the government has requested delegated powers from Parliament, address the critical aspects recently highlighted in the report by the government commission on the implementation of the 1995 pension reform, in particular the excessive length of the transition period to the new system and the still significant projected increase in the equilibrium contribution rate; moreover, ensure that further changes to the social security system are carried out without generating long-term budgetary imbalances; implement the measures aimed at promoting supplementary privately-funded pension schemes, clarifying the possible related budgetary costs.

### ***Labour markets***

The Italian labour market situation continued to improve in 2001, with the unemployment rate falling from 10.4% to a still high 9.5% and female labour force participation increasing. On average, employment grew by almost 2.1 per cent to an estimated 54.6% and the overall participation rate rose to 60.4% (from 59.9% in 2000). Besides wage moderation, the higher employment intensity of growth over the recent years is also due to the increased labour market flexibility “at the margin”, allowing greater use of new and more flexible contracts (part-time, temporary jobs, fixed-term contracts, new apprenticeship). The measures designed to lower labour costs for permanent employees continued to have a significant impact on employment growth during 2000. However, the Italian labour market is still characterised by many weaknesses, notably a persistent low employment rate, especially for women (about 40%) and older workers (only 28% for the 55-64 year old). Wide regional disparities in labour market performances are still a major source of inefficiency. The unemployment rate in the South is at 19.3%, compared to 7.4% in the Centre and only 3.8% in the North. A more decentralised wage-bargaining system should be agreed by the Social partners in order to allow for greater wage differentiation. As a result of stricter protection of workers in permanent jobs in medium and large firms and the still relatively low degree of protection of non-employed and “atypical workers”, the labour market continues to be characterised by a marked dualism. The unemployment benefit system remains limited in scope and uneven, with different schemes and disparities in benefit conditions (level, duration and eligibility criteria). Although the tax wedge on labour costs has been reduced over the latest years, especially that on low-paid workers, it remains relatively high. In view of the above, while vigorously implementing all the Employment Recommendations adopted by the Council in February 2002, the main priorities for Italy should be to:

- i. encourage Social Partners to allow wage-setting mechanisms to better take into account productivity and local labour market conditions, while preserving wage moderation;
- ii. ensure the full implementation of the recent labour market reform package in order to increase labour market flexibility and to promote greater workplace adaptability with a view to facilitating access to employment, while maintaining a proper balance between flexibility and security;
- iii. implement the planned comprehensive reform of the unemployment benefit system in order to extend the coverage and the effectiveness of social protection of the unemployed, while strengthening incentives to work;
- iv. take steps to further encourage increased labour force participation, especially among women, including setting targets to ensure adequate provision of facilities for care of children and other dependants; and among older workers, stepping up and reinforcing incentives to postpone retirement from the labour force; and
- v. continue efforts to reduce the tax burden on labour, especially on low-paid earners, while preserving equity goals and increasing work incentives, within the framework of continued fiscal consolidation.

### ***Product markets, entrepreneurship and the knowledge-based economy***

The Italian economy is relatively less open (as measured by the total trade-to-GDP ratio) than other EU economies of similar size. Labour productivity is above the EU average, but has slightly decreased recently in relative terms. The transposition rate of Internal Market directives is below the March 2002 target of 98.5% and the number of infringement cases for violation of Internal Market rules is among the highest in the EU. Efforts to improve the business environment have started to bear fruit, but administrative procedures remain relatively complex, and competition in the service sector is taking hold rather slowly. Recent measures should contribute to increasing competition in the energy sector, where incumbents retain a very strong market position and prices remain among the highest in the EU; which may be explained in part by a fuel mix strongly based on oil products. Italy's transition to the knowledge-based society may be constrained by the relatively low average levels of educational achievement of the population and the weak R&D and innovation base of the economy. Internet penetration in households and in schools is below the EU average, even if the former is rapidly catching up. The development of e-commerce is relatively slow. In view of the above, the main priorities for Italy should be:

- i. continue to strengthen the overall education and skill base of the population, further increase private sector involvement in R&D and innovation and promote higher ICT take up;
- ii. increase effective competition in the service sectors, particularly professional services, and implement all reforms to extend market opening and further enhance competition in the energy sector in order to allow the pass-on of the benefits of liberalisation to final users, including households and small businesses;
- iii. sustain the efforts undertaken to reduce the administrative burden for businesses, including the time and cost required for registering a new company; and

- iv. raise the transposition rate of Internal Market legislation with the aim of achieving the target of 98.5% of Internal Market directives, and bring down the number of infringement procedures.



## 9. LUXEMBOURG

Real GDP growth decelerated in the course of 2001 but still reached 5.1% on yearly average according to a preliminary estimate. Domestic demand remained robust: private consumption benefited from the tax cuts operated at the beginning of the year, government consumption continued to increase at a rather fast pace and investment proved dynamic. Exports still increased by more than 8% over the year, while imports rose at least as fast, imports of goods remaining very dynamic in line with domestic demand. Employment continued to increase by more than 5%, hardly less than in 2000, though decelerating in the course of the year, while unemployment began to rise at the end of the year. Wages accelerated further in 2001, rising by about 5½ % after 4.6% in 2000. On the contrary, prices decelerated in 2001, the rise in the HICP reaching 2.4% as against 3.8% in 2000. However, underlying inflation kept accelerating, reaching 3.3% in the second half of 2001.

Increasing the low national participation and employment rates, especially for older workers remains a key challenge. Moreover, developments in wages and labour costs require attention and need to be maintained in line with the rest of the euro area in the coming years. To this end, the wage formation process calls for adjustment. Finally, efforts should be undertaken to accelerate implementation of the reform of competition legislation and empowering the competition authority to apply EC law.

### ***Budgetary policy***

In 2001, the general government surplus declined to 4% of GDP partly as a result of decelerating activity and of the tax cuts implemented in the framework of the 1st January 2001 tax reform; but the main factor of decline was a large increase in government expenditure reaching 1.7% of GDP. Further decline in the surplus is expected in 2002, due to cyclical factors and to a second phase of the tax reform; in addition, government expenditure will continue to increase at a very fast pace, public investment, particularly in infrastructures, is expected to reach 4.6% of GDP in 2002, the highest percentage in the whole EU. In 2003, recovery in activity is expected to result in a renewed although moderate increase in the government surplus. However, current government expenditures will continue to expand significantly. In view of the above and considering that Luxembourg is a member of the euro area, budgetary policy should aim to:

- i. contain current government expenditure in 2003 in order to ensure that the increase will not exceed that of total budget expenditure and to this aim endeavour to overcome rigidities in specific kind of current expenditure.

### ***Labour markets***

The overall performance of the Luxembourg labour market was good in 2001. The unemployment rate remained very low and employment growth continued to be strong, largely thanks to the availability of cross-border workers. Nevertheless, the national employment rates remain low and the labour market has been tightening, as revealed by strong nominal wage increases. This underlines the need to better exploit the country's own labour potential, as indicated by low national employment rates for older workers (27%) and women (50%). In 2001, the government made some effort to restrict access to the disability pension scheme and to increase incentives to work longer through an increase of the accrual rate of old-age pension rights for additional years worked beyond the age of 55. In addition, female labour force participation and flexibility in work were encouraged by allowing voluntary access to part-time work by full-time workers. Despite these reforms, incentives to remain in labour force could

be improved by further reforms of early retirement, pre-retirement and disability pension schemes. In view of the above, while vigorously implementing all the Employment Recommendations adopted by the Council in February 2002, the main priority for Luxembourg should be to:

- i. intensify efforts to increase the national employment rate: especially for older workers by reducing incentives for early retirement, and by increasing incentives in pre-retirement and disability pension schemes to remain in employment; and for women by removing obstacles to their entry or re-entry to the labour market (by, inter alia, increasing the availability of child care facilities).

### ***Product markets, entrepreneurship and the knowledge-based economy***

The high degree of openness of the Luxembourg economy stimulates competition on the product markets, which results in very high productivity and prices below the EU average. Network industries are progressively being liberalised and ICT diffusion is progressing well. However, some elements of the competition framework, such as obsolete legislation on prices, have the potential to restrict competition on product markets. Moreover, the lack of empowerment of the competition authority makes it difficult to ensure effective enforcement of EC competition rules. In March 2002 the rate of transposition of Internal Market directives (97.7%) remained below the target of 98.5%. In view of the above, the main priorities for Luxembourg should be to:

- i. implement the announced reform of competition legislation, including the abolition of fixed and monitored prices, the empowering of the competition authority to apply EC competition law, and the reform of public procurement legislation;
- ii. take measures to reduce the administrative burden for businesses, including the time and cost required for registering a new company, and to develop e-government; and
- iii. raise the transposition rate of Internal Market legislation with the aim of achieving the target of 98.5% of Internal Market directives.

## 10. NETHERLANDS

Real GDP growth decelerated at the beginning of 2001, reaching only 1.1% in average for the year as against 3.5% in 2000. Exports as well as imports decreased substantially following the decline in international trade; domestic demand was also subdued, private investment decreasing from the second half of 2000 and consumption reacting abnormally to the large increase in households disposable income, which was boosted by fast rising wages and the effects of the tax reform at the beginning of the year. Real GDP growth is expected to pick up again in the course of 2002, as private consumption should accelerate and exports should follow the recovery in international trade: the expansion could reach around 1½% in 2002 and some 2¾% in 2003. Employment kept increasing fast in 2001, though decelerating in the second part of the year. As a result of sizeable labour hoarding, the productivity of labour declined and unemployment remained stable until the end of 2001. The increase in employment should decelerate significantly in 2002 and recover only modestly in 2003, leading in both years to a substantial rise in unemployment, the level of which should, however, remain much lower than in neighbouring countries. Moreover, labour markets are likely to remain quite tight. The current upward pressure on wages is therefore unlikely to disappear overnight. Inflation, which had accelerated significantly in the course of 2000 to about 3% at the end of the year, partly as an effect of rising oil prices, jumped to 5% in 2001, due to a rise in indirect taxation which was part of the tax reform and also to still rapidly rising wages; price increases are expected to decelerate only progressively in the coming years.

Increasing further labour market participation by drawing currently inactive people into the labour market remains a key challenge. Moreover, due to substantial acceleration in wages in the latest years, part of the very significant gains of competitiveness achieved during nearly 15 years have been lost. This might reduce the benefits for the Dutch economy from the world recovery and dampen future growth prospects. A second key challenge is therefore to ensure, as soon as possible, a renewal of wage moderation and to tackle relatively slow labour productivity growth, in order to maintain the competitiveness of the economy.

### ***Budgetary policy***

The general government surplus declined from 1.5% of GDP in 2000 to 0.2% of GDP in 2001 (excluding UMTS receipts), mainly as a result of a significant reduction in budgetary revenues. The wide-ranging tax reform, which came into effect on 1 January 2001, induced a decline in government receipts from the income tax and from the social security contributions, only partly compensated by the increase in indirect taxes (specifically the rise in the standard VAT rate from 17.5% to 19%). This effect was aggravated, at the end of the year, by the impact on tax revenues of the cyclical deceleration in the economy. Moreover, the EMU-balance deteriorated 0.3 percentage points because of a one-time expenditure due to the acquisition of the stake of DSM in EBN. This acquisition is to be seen as part of the process to liberalise the Dutch gas market. Although some spending was reallocated in the Spring of 2001 towards priorities in the areas of healthcare, education and security, the expenditure ceilings were respected thanks to lower-than-expected interest payments and social security outlays. In the absence of any discretionary measure, letting the automatic stabilisers fully play, the government accounts are currently expected to be broadly in balance in 2002 and to post a moderate deficit in 2003 which might reach 0.4% of GDP, according to the Spring Commission forecasts. In view of the above and considering that the Netherlands is a member of the euro area, budgetary policy should aim to:

- i. ensure that the budgetary stance in 2002 does not contribute to inflationary pressures, should they persist notably as a result of excessive wage increases; and
- ii. avoid a deterioration in the government balance in 2003 and, to this end, contain current government expenditure within clearly defined ceilings set in real terms.

### ***Labour markets***

The Dutch labour market continues to perform very well, with the lowest unemployment rate in the European Union and employment rates already above the Lisbon targets for the EU as a whole. Despite the cyclical slowdown and still robust employment growth in 2001, labour market tightness continued to be a major driving force behind strong wage increases. Further improvement of employment rates will depend on continued growth of female participation and a stronger activation of older persons and minorities. Moreover, there exists a substantial untapped reserve of labour among benefit claimants, e.g. 7% of the labour force receives unemployment and social benefits and 11% receive disability benefits (although some of those with partial disabilities are working). Some new measures were introduced, and some existing ones refined, in order to strengthen work incentives for benefit recipients, older workers and low wage earners. However, the discussion on a reform of the disability scheme has not yet led to tangible results; and the cumulative effect of benefits, including local subsidies, continues to create inactivity traps. In view of the above, while vigorously implementing all the Employment Recommendations adopted by the Council in February 2002, the main priority for the Netherlands should be to:

- i. make work pay via reforms of benefit eligibility, conditionality and rules for cumulation of benefits. Carry through and implement the planned reform of the disability scheme, thereby, in view of the size of the stock of recipients, paying attention to both the inflow and to the activation of those who already receive benefits.

### ***Product markets, entrepreneurship and the knowledge-based economy***

The Dutch economy is very open (as measured by the total trade-to-GDP ratio). This assures a high level of competition and relatively low price levels in sectors producing tradable goods and services. Market liberalisation has contributed to relatively low prices for telephone calls and electricity use. The transposition rate of Internal Market directives met the March 2002 target of 98.5%. Measures have been taken to encourage ICT use and reduce the shortage of ICT experts. However, labour productivity growth has been relatively slow as a result of, among other things, the rapid employment growth in services, the low level of competition in some more sheltered services sectors (e.g. notaries, childcare, taxis and broadband Internet), and insufficient business investment, particularly in R&D. In spite of efforts made to stimulate research and innovation, business expenditures on R&D as a percentage of GDP remain below the EU average, which may be associated with the lack of a science- and technology-oriented labour force. The typical time and costs required for setting up a Private Limited Company are above the EU average. In view of the above, the main priorities for the Netherlands should be to:

- i. create the conditions for a further increase in business investment in R&D by taking measures to raise the number of science and technology graduates entering into the labour force and by promoting a more technology-oriented education;

- ii address market regulations which may impair competition in service sectors, including notaries, childcare, taxis and broadband internet; and
- iii. take further measures to develop e-government and to reduce the administrative burden on business, including the time and cost required for registering a new company.

## 11. AUSTRIA

Output growth decelerated in 2001 to about 1%, following buoyant economic activity during the period 1998-2000. Weak demand, worsening business confidence and excess capacities lead to a fall in equipment investment, at the same time as construction investment plunged. Domestic demand was furthermore curbed by budgetary consolidation. Although exports fell in step with the slowdown of economic activity of main trading partners, the growth contribution of net exports remained clearly positive due to a strong deceleration in import growth. In 2002, domestic demand is expected to pick up somewhat, thereby offsetting a further decline in export growth. As a result, GDP growth on average should remain more or less steady. In 2003 the projected improvement in both external trade and domestic demand should bring output expansion close to potential, i.e. to some 2½%. Oil price developments and increases in excise duties drove up prices until May 2001. Higher housing costs also added to price pressures. In 2002, by contrast, the expected easing of import prices should dominate consumer price developments. In 2003, the increase in the HICP is expected to remain at the 2002 level. The expansion in total employment came to a halt in 2001. Employment is projected to decline slightly in 2002 but job growth should resume in 2003. Unemployment started to rise in 2001 and is expected to continue its rise in 2002 to some 4.0% of the labour force before reversing in 2003.

Although the budgetary situation improved considerably in 2001, sustainability in a longer-term perspective is not ensured given the expected strong expenditure pressure stemming from the ageing of the population. In particular, a low effective retirement age and high benefit levels continue to exert significant upward pressure on public pension outlays. Although pension scheme reforms and moderate benefit rises in recent years have partially addressed these issues, much remains to be done to put the pension system on a sustainable footing. Output growth in Austria has been strongly based on factor expansion while total factor productivity growth remains rather moderate. Moreover, a weak technology base stands in the way of an expeditious transition to a knowledge-based economy. Although different initiatives have been undertaken in this regard, such as an increase in R&D expenditure or the reinforcement of links between business and universities, it remains to be seen whether these measures are sufficient to help Austria to catch up with other more advanced EU countries in terms of a knowledge based economy.

### *Budgetary policy*

Budgetary consolidation in 2001 was impressive. General government finances improved from a deficit of 1.5% of GDP (excluding UMTS proceeds) in the year before to a balanced position. As this was achieved against output growth much below trend the improvement in the cyclically adjusted position was even stronger. Expenditure growth was kept at bay thanks to the ongoing effects of the reform of the pension system and public administration. Due, however, to exceptional one-off expenditure<sup>2</sup>, the ratio of expenditure-to-GDP (excluding UMTS proceeds) rose slightly compared to the previous year; it is, however, projected to fall visibly in 2002. The favourable outcome in 2001 is mainly due, therefore, to a strong increase in tax revenue as a result of predominantly base broadening measures. As a consequence, the tax burden climbed to a record high. The stability programme update projects a balanced budget also for the years 2002 and 2003. To attain the targets of the programme, structural savings measures will be needed at the level of the Länder, which committed themselves to

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<sup>2</sup> Compensation payments for forced labour in World War II, capital injection for the Federal Railways (ÖBB)

considerable surpluses in the framework of a national stability pact. Despite recent structural reforms, the sustainability of the pension system is not secured in view of the sharp rise in the age-dependency ratio in coming decades. In view of the above, and considering that Austria is a member of the euro area, budgetary policy should aim to:

- i. implement measures leading to structural expenditure savings, especially at lower levels of government, so as to meet the target of a balanced budget in 2002 and 2003 set in the updated stability programme of December 2001;
- ii. ensure that the planned reduction in the high tax burden enhances incentives to work and invest and does not conflict with the target of maintaining budgetary balance; this requires additional savings efforts at all levels of government; and
- iii. review the public pension system to ensure the sustainability of public finances, addressing in particular the low average effective retirement age and the level of pension benefits;

### ***Labour markets***

The overall performance of the Austrian labour market remained very satisfactory in 2001. Although the economic slowdown has started to be felt and unemployment has started to increase, the unemployment rate is, at 3.6%, still among the lowest in the European Union. Skills gaps, which have occurred in the ICT sector, manufacturing and services, are likely to be attenuated by the current slowdown. While the total employment rate is, at 68% in 2000, above average, the employment rate of older workers appears to be stagnating at a very low level of 29%. This is problematic in view of the high burden stemming from population ageing. Following the pension reform of 2000, the reduced inflow into retirement experienced in 2001 looks encouraging, but it is still too early to see the full impact on the average retirement age. In 2001, a number of active measures that proved successful in the past have been strengthened or refined. However, disincentives to work after the minimum age for early retirement remain, and the lengthening of benefit duration for older workers is likely to produce adverse effects, thus weakening the impact of the early retirement reform to which it is an accompanying measure. In view of the above, while vigorously implementing all the Employment Recommendations adopted by the Council in February 2002, the main priority for Austria should be to:

- i. speed up reform of tax and benefit systems to remove disincentives for older workers to remain active in the labour market.

### ***Product markets, entrepreneurship and the knowledge-based economy***

Despite Austria's lower exposure to international competition than for other small Member States, labour productivity and price levels are in line with the EU average. Important measures are being taken to rapidly liberalise network industries and to appoint sectoral regulators. Further improvements in the regulatory framework would foster competition and increase pressure for companies to innovate. In March 2002 the rate of transposition of Internal Market directives (98.1%) remained below the target of 98.5%. Austria's lag in business R&D and in high tech patents also contributes to its relatively weak technology base which risks delaying the transition to the knowledge-based economy. The typical time and costs requirements for setting up a private limited company are relatively high. In view of the above, the main priorities for Austria should be to:

- i. continue to take measures aimed at promoting and diffusing ICT and R&D in businesses, in order to increase business expenditure on R&D as a percentage of GDP;
- ii. improve Austria's integration within the Internal Market by accelerating the transposition of Internal Market directives with the aim of achieving the target of 98.5% of Internal Market directives and by ensuring a full application of Community rules on public procurement by all levels of public authorities;
- iii. improve the regulatory framework by increasing the effective powers of the telecommunications regulator; and
- iv. take further measures to reduce the administrative burden on business, including the time and cost required for registering a new private limited company.



## 12. PORTUGAL

Economic growth decelerated to about 1¾% in 2001, as a sharp slowdown in domestic demand was only partly offset by an improvement in net exports. This ends an extended period of growth driven by domestic demand. The efforts of private sector agents to redress their balance sheets, following the sharp rise in indebtedness levels in recent years, are expected to limit domestic demand growth also in 2002-03, estimated to average about 1¼%. With foreign demand expected to be weak in the first half of 2002 output growth will also remain subdued but should pick up in step with the recovery of global demand in the latter part of the year. In view of the negative statistical overhang in the beginning of 2002, annual GDP growth is expected to reach only around 1½% in 2002, before reviving to a growth rate of some 2¼% in 2003. After an upsurge in inflation in 2000 and through 2001, due partly to temporary factors, inflationary pressures have subsided since the second quarter of 2001. Inflation measured by the HICP is projected to pursue its deceleration in the near term, attaining a value of around 2½% on an annual average in 2003. The unwinding of the tight labour market situation coupled with the projected low wage increases in the public sector are expected to have a moderating impact on wage developments and, subsequently, price inflation. Employment growth is forecast to slow down significantly during the 2002-03 period, after expanding by 1.6% in 2001, while unemployment should rise somewhat, with the unemployment rate averaging about 5% in 2003.

A new government was sworn in on 6 April 2002. The consolidation of public finances will be a major policy challenge for this government during its term. Fiscal consolidation faltered in 2001, due also to significant revenue shortfalls. However, viewed over the longer period it is the strong dynamics of government expenditure, which appears to be at the root of the sluggish budgetary consolidation process. The reversal of the rapid upward trend in general government outlays is, therefore, a priority matter on the road to sounder public finances. The Portuguese economy has lost competitiveness in recent years, as evidenced also by a large trade deficit. A number of factors have contributed to this, in particular low growth of labour productivity coupled with high wage settlements. The unsatisfactory level and growth of labour productivity is associated, *inter alia*, with a low level of educational attainment of the workforce which continues to be one of the most significant structural problems. The pursuit of higher levels of productivity is also constrained by insufficient competition in product markets. Portugal is one of the EU countries most exposed to the budgetary consequences of population ageing. A number of recent reforms have addressed this issue. Although these reforms will improve the financial balance of the pension system in the longer term, further action seems to be required to ensure sustainability of public finances. Moreover, the strong dynamics of health-care expenditure suggests that the ongoing reform process to improve the control and efficiency of expenditure in the health care sector needs to be pursued with resolve.

### ***Budgetary policy***

Fiscal consolidation halted in 2001, with the government deficit increasing to an estimated 2¾% of GDP (2¼% in 2000 excluding UMTS proceeds), which compares with an initial target of 1.1%. This is much higher than expected in December 2001, when the authorities submitted their stability programme update. Slower economic growth than expected is an important factor behind the considerably worse than targeted budgetary outcome in 2001. However, other factors are also behind this, notably an underestimation of the revenue losses implied by the reform of direct taxes implemented in 2001 and lower-than-projected efficiency gains in tax collection and administration. Moreover, despite a restrictive package adopted in June, current primary expenditure exceeded the target. Finally, the strong upward revision between December 2001 and April 2002 was caused by

much higher-than-estimated deficits at the level of local governments and a statistical reclassification of certain capital transactions between the government and public enterprises. The December 2001 update of the stability programme maintains the objective of balancing general government accounts by 2004. This objective was reconfirmed by the new government. In view of the strong deterioration of the deficit in 2001 this requires a considerable more ambitious fiscal consolidation policy in the period 2002-04. In the Ecofin Council meeting of 12 February 2002, the Portuguese government committed itself to respect the 3% of GDP reference value for the general government deficit in the current year and confirmed its commitment to reach a close to balance position in 2004. In view of the above, and considering that Portugal is a member of the euro area, budgetary policy should aim to:

- i. meet the 1.8% of GDP deficit target for 2002; to this end take the necessary measures in the supplementary budget under preparation and strengthen budgetary surveillance at all levels of government;
- ii. achieve a balanced budgetary position by 2004; this will require discretionary measures in addition to those included in the 2001 updated stability programme;
- iii. implement the measures announced in June 2001 to rein in expenditure with determination with a view to reducing the expenditure dynamics of general government; and
- iv. continue the process of pension reform by implementing measures in addition to those contemplated by the 2001 reform to ensure sustainability of the pension system in the medium and longer term; introduce effective measures to curb the unsustainable pace of health care expenditure, particularly for the consumption of pharmaceuticals.

### ***Labour markets***

The labour market situation remained favourable in Portugal in 2001, despite the marked decline in economic activity. The unemployment rate continued to be one of the lowest in the Union at just above 4%. Employment grew by 1.5% and the employment rates are all (whether overall, female or that of older worker) well above the EU-averages. Wage levels and labour costs remain among the lowest in the Union, but the tight labour market situation in some sectors and strong wage increases in the public sector have triggered nominal wage growth of over 6% in 2000-01. Together with the modest increase in labour productivity, real unit labour costs have increased by some 3½% in 2000-01, well above the basically unchanged level noted for the EU as a whole. In addition, the level of labour productivity is low in Portugal, partly explained by the very low levels of educational attainment (also for the younger age groups). On average, the share of the population that has attended at least upper secondary education was only 21% in 1999 (compared to 59% on average in the EU). Although, Portugal has increased spending on education substantially in recent years, the continued high incidence of early dropouts and a need to streamline and simplify the very many measures suggest a relatively inefficient use of resources. The share of workers with temporary contracts has almost doubled in the last five years, partly as a result of the stricter employment protection legislation for workers with regular contracts. In view of the above, while vigorously implementing all the Employment Recommendations adopted by the Council in February 2002, the main priorities for Portugal should be to:

- i. improve education and training systems in the framework of a better articulated lifelong learning strategy in order to raise the employability and adaptability of the labour force and increase labour productivity;
- ii. promote wage developments that are consistent with the maintenance of competitiveness and price stability; and
- iii. modernise the labour market institutions, inter alia by adapting employment contract regulations, in order to minimise the risk of segmentation between regular and atypical contracts, taking into account the need for a proper balance between flexibility and security.

### ***Product markets, entrepreneurship and the knowledge-based economy***

Partly because of its geographical position, the Portuguese economy is relatively less open (as measured by the total trade-to-GDP ratio) than other Member States of comparable size. Labour productivity is the lowest in the EU and is growing only slowly. Among the determinants of the low productivity and overall competitiveness of the economy are the low level of educational attainment of the workforce and the very weak involvement of the business sector in R&D and innovation. Several measures have been taken to promote ICT diffusion, increase R&D activity and reduce the administrative burden on businesses. Liberalisation of network industries has made progress but there is still scope for enhancing competition, as incumbents have retained strong market positions and prices remain relatively high. Portugal's record in transposing Internal Market directives is below the March 2002 target of 98.5%. Competition in overall product markets would greatly benefit from the implementation of the announced reinforcement of the institutional setting for the enforcement of competition policy and the control of sector-specific State aid, which remains the highest in the EU and is only decreasing at a slow pace. In view of the above the main priorities for Portugal should be:

- i. continue to strengthen the overall education and skill base of the population and further promote the stronger involvement of businesses in R&D and innovation, together with higher ICT take up;
- ii. enhance effective competition in liberalised utilities and especially in the energy sector, in order to reduce the prices for users;
- iii. monitor the cost-effectiveness of sector-specific State aid schemes with a view to their possible reduction; and
- iv. continue progress in raising the transposition rate of Internal Market legislation with the aim of achieving the target of 98.5% of Internal Market directives.

### 13. FINLAND

Due to a sharp decline in export growth accompanied by heavy de-stocking the Finnish economy experienced a sharp slowdown in 2001, with GDP growth being estimated at 0.7 % after 5.6 % the year before. A gradual recovery of the external contribution to growth is expected to revive economic activity in 2002-03. Furthermore, private consumption should gain strength owing to continued income tax cuts, moderating inflation and continued favourable monetary conditions. However, against the background of a low rate of capacity utilisation in manufacturing and an estimated decrease in demand for additional housing and business premises, investment is anticipated to be weak. Inflation (HICP) eased somewhat to 2.7% in 2001 as the impact of higher prices for fuel and food faded towards the end of the year. However, prices of services rose fairly strongly and this factor is also expected to put a floor under price inflation in 2002-03. Employment continued to increase in 2001, though at a steeply declining pace. In 2002, employment is expected to decrease in the light of continued subdued growth in the export-oriented manufacturing sector and only limited employment expansion in the service sector. Consequently, unemployment is anticipated to edge up in 2002, with a reversal expected only in 2003.

At 9.1% of the labour force the unemployment rate remained in 2001 clearly above the average of the euro area. Most of the unemployment appears to be of a structural nature. Although efforts have been made to better target and tailor ALMPs and to help the inclusion of the most hard-to-place unemployed in the labour market, while benefit eligibility criteria were tightened, other measures such as the increase in unemployment benefits run contrary to the aim of increasing incentives to work. Finland is one of the Member States most exposed to the effects of an ageing population. The government is committed to pension reform with a view to making public finances sustainable in the long term. A number of the reform steps go in the right direction but for several of the measures the envisaged period of implementation appears unduly long. Finland remains one of the countries with the highest price level in the EU. This is due in part due to insufficient competition in certain sectors calling for stepped up efforts in this area.

#### ***Budgetary policy***

Central government finances are estimated to weaken from a surplus of 1.9% of GDP in 2001 to 1% in 2002. The government's aim of achieving a structural surplus in central government finances of 1½ - 2% of GDP over the medium term appears now very difficult to achieve, the more so as, in order to boost employment creation, the government might decide to reduce further income tax rates. Against the background of the government's aim of preparing for the forthcoming age-related expenditure pressures tax cuts need to be accompanied by expenditure restraint. Central government spending in recent years has repeatedly overshoot the medium-term spending guidelines. In addition to a weakening of central government finances, the financial balance of local governments has stayed persistently in deficit since 1997, except for 2000 when company taxes were particularly buoyant. Budgetary discipline at general government level could be enhanced by a recently adopted legislation requiring local governments to aim for medium-term budgetary balance from 2002 onwards. However, in the absence of an enforcement mechanism in the legislation it is uncertain whether this regulation will achieve the envisaged results. In view of the above, and considering that Finland is a member of the euro area, budgetary policy should aim to:

- i. avoid a significant deviation from the medium-term spending guidelines of keeping government expenditure in real terms at the level of 1999; to this end adhere tightly to the

budget's expenditure target for 2002 and adopt the necessary expenditure reducing measures in the budget for 2003;

- ii. improving the budgetary discipline at local government level by establishing an enhanced surveillance mechanism to the recently adopted regulation requiring local governments to aim for budgetary balance in their finances in the medium term; and
- iii. continue with determination the ongoing process of pension reform, in particular adopt and implement at an early stage the envisaged changes in the pension formula by taking into account the increased life expectancy and extending the period of calculation for pensionable earnings to the whole work career.

### ***Labour markets***

The performance of the Finnish labour market in 2001 was mixed. While employment continued to grow and unemployment to decline, real unit labour costs increased and labour productivity fell due to a sharp slowdown in the economic growth. As a result, employment growth is expected to cease in 2002. The unemployment rate remains at a high level, 9.1% in 2001, and is expected to rise in 2002. Unemployment is predominantly structural in nature, with large regional differences. The government's responses to labour market problems focused strongly on the reduction of overall taxes on labour between 1997 and 2002. However, these reductions have been essentially proportional, thus doing little to redress the relative position of low-wage earners, in particular, with respect to high marginal effective tax rates. In 2001, the government introduced measures to improve the effectiveness of active labour market programmes (ALMPs), to prevent exclusion of the hard-to-place unemployed from the labour market and to reform pension systems with the aim of increasing flexibility regarding the retirement age and increasing incentives to remain longer in the labour force. However, the number of working-age people in various benefit schemes and ALMPs remains high and the late implementation of the latter reforms weakens their effect on the baby-boom generation and risks delaying the achievement of the government's objective of raising the effective retirement age. In addition, the already-decided measures to increase the level of unemployment benefits in 2002 run contrary to the aim of increasing incentives to work and undermine the effects of tax reductions and ALMPs. In view of the above, while vigorously implementing all the Employment Recommendations adopted by the Council in February 2002, the main priorities for Finland should be to:

- i. make work pay in order to reduce the high level of structural unemployment. Reforms should cover benefit schemes, including early retirement arrangements, and the lowering of the relatively high marginal effective tax rates for low wage earners in particular. In this context the eligibility criteria and job protection legislation should also be reviewed; and
- ii. continue to increase the efficiency of active labour market programmes and to refocus them to the needs of those most prone to the risk of long-term unemployment.

### ***Product markets, entrepreneurship and the knowledge-based economy***

Due to its peripheral location in the European Union, the Finnish economy is potentially less exposed to international competition than most other Member States. Consumer price levels are among the highest in the European Union, which is partly due to the relatively high degree of market concentration in some sectors, such as the media and retail distribution. The Finnish transposition rate of Internal Market directives is among the highest in the EU and telecommunication and electricity markets have been fully liberalised. Although the resources and powers of the competition authorities

have been increased, Finland is one of the few Member States, which has not taken measures to empower the national competition authority to apply EC competition law directly. Moreover, while improvements have been made recently, the value of public procurement that is publicly advertised is below the European average and private sector participation in the provision of public services is low, especially at the local level. Measures have been taken to promote entrepreneurship but the time required to register a private company remains among the longest in the EU. Finally, Finland is one of the best performers in the European Union in the field of the transition to the knowledge-based economy. In view of the above, the main priorities for Finland should be to:

- i. enhance competition in public service provision at the local level via increased participation of the private sector and competition between public service operators;
- ii. facilitate business creation by reducing further the time required for registering a new company; and
- iii. give the Finnish Competition Authority powers to apply Articles 81 and 82 of the EC Treaty.

## 14. SWEDEN

Sweden experienced a sharp slowdown in 2001 and real GDP growth decelerated to 1.2% from 3.6% in 2000, heavily influenced by the global slowdown and in particular of the slump in the ICT sector. However, the expected gradual acceleration of the world economy in 2002 and 2003 should result in stronger external demand. The relatively favourable fundamentals in Sweden should also aid a recovery in domestic demand in 2002 and 2003. Overall, real GDP is expected to grow by around 1.7% in 2002 and by some 2.8% in 2003. HICP inflation increased substantially in 2001 and averaged 2.7%, partly due to temporary factors. However, the indications are that inflationary pressures should diminish from the second quarter of 2002 and remain close to 2% into 2003. Employment growth has been robust in recent years and was 2% still in 2001, which has contributed to a substantial fall in the unemployment rate, to 5.2% in 2001. However, some lagged effects of the slowdown of economic activity in 2001 are expected and a slight increase in unemployment is expected in 2002. This should be reversed as the economy gains momentum in 2003.

Enhancing the growth potential of the economy remains a key challenge, as productivity per person has fallen in recent years compared with the EU-15 average. Policies aimed at strengthening entrepreneurship and growth of firms as well as efforts to improve incentives to work should be given high priority. While Sweden ranks high in terms of employment rates, increasing labour force participation and foster employment nevertheless remains a key challenge in the medium term in order to cope with an ageing population. A very high tax burden combined with relatively generous benefit schemes reduce the incentives to work. Moreover, the effectiveness of labour market programmes need to be monitored. Measures to enhance competition in some sectors and to increase the efficiency of the public sector are key challenges in order to address the high price levels and the weak labour productivity performance.

### *Budgetary policy*

In 2001, the general government surplus rose markedly, by 1 percentage point, to 4.8 per cent of GDP. According to the 2002 Spring Fiscal Policy Bill, continued large surpluses of 1.8 per cent of GDP in both 2002 and 2003 are expected. Swedish medium-term budgetary policy is threefold and consists of (i) nominal ceilings on central government expenditure set annually for three years ahead, (ii) a medium-term balanced budget constraint for local governments and (iii) a 2 per cent of GDP surplus target for general government finances on average over the business-cycle. The margin created by achieving higher surpluses than targeted has been used partly for tax relief and partly for debt reduction. Gross debt fell below 60% of GDP in 2000 and is expected to continue to fall and reach 48.3% of GDP in 2004, according to the 2002 Spring Fiscal Policy Bill. This debt reduction, together with the reformed pension system, form an important part of Sweden's strategy for coping with the ageing of the population. In view of the above, budgetary policy should aim to:

- i. continue with the strategy of lowering taxes for low and medium wage earners in 2002 and at the same time ensure adherence to the central government expenditure ceiling; and
- ii. achieve in 2003 a general government surplus in accordance with the government's medium-term surplus target of 2 per cent of GDP over the cycle for the government finances while maintaining tight expenditure control.

### ***Labour markets***

The Swedish labour market continued to improve in 2001, despite the substantial slow down in economic growth. Unemployment declined to around 5% of the labour force, while employment grew by almost 2%, boosting further the already high employment rates. In particular, the employment rate of older workers (55-64 years old) at almost 65% in 2000 is markedly higher than in other Member States. The remaining “labour reserve” for a further increase of labour supply in the medium term is thus limited. In fact, relatively high nominal wage increases in 2001 (compared to the modest performance of labour productivity), in e.g. the construction and services sectors, suggest a certain shortage and mismatch of labour already now. This is partly alleviated by the strong emphasis put on training in Sweden, where almost 5% of the labour force participates in various active labour market programmes (ALMPs) or the special, temporary education programme, which both contribute to an improved adaptability of the work force. However, recent evaluations of some types of ALMPs indicate a relatively mixed outcome (in terms of the *net* gains in employment), underlining the importance of further improving their efficiency. Despite recent measures, the tax burden on labour and, in particular, on low wage earners remains one of the highest in the Union. Relatively generous benefit levels contribute to high net replacement rates, even if comparatively strict eligibility criteria (in combination with the active employment policy) limit the risk of long-term unemployment in Sweden. In view of the above, while vigorously implementing all the Employment Recommendations adopted by the Council in February 2002, the main priorities for Sweden should be to:

- i. pursue further the reforms of tax and benefit systems to promote work incentives; and
- ii. further improve the efficiency of active labour market programmes (ALMPs) and continue to target them at those most prone to the risk of long-term unemployment, as well as to meet the demands of the labour market.

### ***Product markets, entrepreneurship and the knowledge-based economy***

Sweden’s openness (as measured by total trade-to-GDP ratio) is higher than the other Nordic economies and notably increased in the 1990s, but price levels remain high and labour productivity is below the EU average. The record in transposing Internal Market directives is excellent, State aid is among the lowest in the EU, and reforms of network industries are well advanced. However, competition in public services provision is still insufficient at the local level. Competition is also insufficient in some sectors such as the retail market for pharmaceutical products, a state-owned monopoly, and food trade. Sweden has the highest total R&D expenditure in the EU although it is highly concentrated in a few knowledge-intensive sectors. The uptake of ICT by the population is proceeding at a high pace and the share of the ICT industry in total production is large compared to other Member States. In view of the above, the main priorities for Sweden should be to:

- i. enhance competition in public service provision at the local level via increased participation of the private sector (profit and non-profit) and via competition between public service operators; and
- ii. step up efforts to enforce competition in those sectors where competition has been found to be inadequate, such as the retail market for pharmaceutical products and food.



## 15. UNITED KINGDOM

United Kingdom economic activity held up well in 2001 as a whole. Depressed net exports associated with the weaker global economy were offset by exceptionally strong growth in household expenditure. GDP rose by 2.2% in the year as a whole. Growth in 2002 is expected to be a little lower, at around 2%, as a result of the global slowdown. However, within 2002, growth is expected to recover as growth of the world economy rises and the economy continues to be supported by growth in domestic demand, in part as a result of monetary loosening in 2001 and planned rises in government current and capital expenditure. Growth in 2003 is expected to be a little above trend as UK export markets grow respectably. Inflation is projected to remain subdued in 2002 and 2003 as output remains close to potential. In particular, increased wage pressures are not expected to emerge despite unemployment remaining low at no more than 5.5%. HICP inflation is projected to average under 2% in 2002 and 2003.

The relatively low level of productivity remains a key challenge. Productivity per person employed is below the EU average although the gap has been declining since 1995. As far as the labour market is concerned, the key challenge remains the high concentration of unemployment and inactivity in certain communities. Regional unemployment disparities continued to rise, although differences within regions remain wider than differences between them. The third key challenge is to improve the quality of UK public services, notably in the transport sector.

### *Budgetary policy*

The government surplus was 0.9% of GDP in 2001. The projections in the convergence programme show the government finances moving into small deficit of 0.2% of GDP in financial year 2001-02 which rises to a deficit of 1.1% of GDP in 2002-03 and persists around that level in the remaining years of the programme, to 2006-07. A deficit of around 1% of GDP now emerges, one year earlier than in the previous update, largely as the result of temporary economic factors (e.g. a lower level of GDP than previously projected, and lower financial company profits). This 1% of GDP deficit persists in the projections, both unadjusted and cyclically adjusted, as a result of a very cautious trend growth assumption of 2.25% per annum and as a result of addressing the low level of government investment – as suggested in the 2001 BEPGs. Gross debt relative to GDP was 39% in 2001. In the convergence programme it is projected to fall to 36.3% by 2006-07. With a low and falling debt to GDP ratio, the UK is in a good position to meet the consequences of ageing populations and the public finances are sustainable on current policies. In view of these developments, budgetary policy should aim to:

- i. ensure, in preparing the budget and in framing future expenditure plans, that in 2003-04, an outturn for the general government balance can be expected that respects the terms of the Stability and Growth Pact of a budgetary position that is close to balance or in surplus; and
- ii. allow public investment, net of depreciation, to rise from 2001-02, as projected in the convergence programme, and as suggested in the 2001 BEPGs.

### *Labour markets*

The UK labour market remains among the best-performing in the EU. In 2000, the UK hit all of the Lisbon/Stockholm employment targets, with an overall employment rate of 71.5%, a female employment rate of 64.8% and an employment rate for older workers of 50.8%. Unemployment has

risen slightly in recent months (to 5.1% s.a. in December 2001) but remains close to its lowest level in over two decades, as does long-term unemployment, which continues to fall as a share of the total. The range of active measures aimed at tackling long-term unemployment and inactivity has been refined, while recent reforms of benefit administration will introduce a more work-focused approach for those on sickness and disability benefits who are able to work. However, the number of working-age people claiming out-of-work sickness and disability benefits continued to rise to almost 2.6 million in May 2001, an increase of 2.6% over the previous year. More than 2 million of these have been claimants for a year or more. Regional unemployment disparities continued to rise, although differences within regions remain wider than differences between them. Local concentrations of unemployment and inactivity in several areas throughout the nation remain a concern. In view of the above, while vigorously implementing all the Employment Recommendations adopted by the Council in February 2002, the main priorities for the United Kingdom should be to:

- i. reinforce active measures targeted at those communities and individuals most prone to the risk of concentrated or long-term unemployment and inactivity; and
- ii. reform sickness and disability benefit schemes to provide people who are able to work with the opportunities and incentives to do so.

### ***Product markets, entrepreneurship and the knowledge-based economy***

The United Kingdom's economic environment is favourable to entrepreneurship with low levels of regulation and relatively low corporate tax rates. State aid is among the lowest in the EU and liberalisation of the network industries is well advanced. However the UK's level of productivity remains relatively low which is partly due to factors such as weak competition in some sectors (e.g. retail banking, postal services and the professions), skills shortages and under-investment in the economy including public services such as the railways. The UK Government has announced a substantial increase in investment in the transport sector through its 10-year plan for transport. The UK's transposition rate of Internal Market directives was, at 98.7% in March 2002, above the target of 98.5%. As regards the knowledge-based economy, IT expenditure (as a % of GDP) and the level of internet access are both above the EU average, although the take-up of broadband internet in the UK is relatively low. In view of the above, the main priorities for the United Kingdom should be to:

- i. continue to improve competition, building on existing policy measures, in sectors such as retail banking, postal services and the professions; and
- ii. deliver the announced infrastructure investment in the railways, establish a new railway infrastructure company and improve the regulation of the railway sector.