II

(Acts whose publication is not obligatory)

COUNCIL

COUNCIL RECOMMENDATION

of 26 June 2003

on the broad guidelines of the economic policies of the Member States and the Community

(for the 2003-2005 period)

(2003/555/EC)

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular to Article 99(2) thereof,

Having regard to the recommendation from the Commission,

Having regard to the discussion by the European Council on 19-20 June 2003,

Whereas a Resolution on the recommendation from the Commission was adopted by the European Parliament,

HEREBY RECOMMENDS:

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I. GENERAL ECONOMIC POLICY GUIDELINES

1. MEETING THE LISBON STRATEGIC GOAL — THE ECONOMIC POLICY CONTRIBUTION

The EU is at a crucial juncture in its history. Following the successful introduction of euro notes and coins, the EU is now on the eve of an historic enlargement which will increase its size to 25 Member States and create an economic entity with a population of more than 450 million. At the same time, the world economy has been facing several uncertainties casting a shadow on economic prospects, certainly in the short-term but possibly also in the medium-term.

At Lisbon, the EU set itself **a new strategic goal for the current decade: 'to become the most competitive and dynamic knowledge-based economy in the world capable of sustainable economic growth with more and better jobs and greater social cohesion'**. The current global economic environment reinforces the need to a speedy implementation of the Lisbon strategy. Successful implementation of this strategy depends upon simultaneous and coherent policy action being taken in a wide range of areas in the economic, social and environmental domains. **These broad economic policy guidelines, while taking account of short-term requirements, concentrate on the contribution that economic policies can make over the next three years to the Lisbon agenda**. In line with the arrangements on streamlining and the conclusions of the Brussels Spring European Council, the BEPGs focus on the key economic policy issues and priorities for the next three years. They are at the heart of the policy coordination endeavour that underpins economic governance in the EU and its Member States. The guidelines testify to the EU's recognition of the imperative for higher and sustainable growth rates and its resolve to take the necessary action to achieve this result. Sound macroeconomic conditions and policies are a prerequisite for a sustainable increase in economic prosperity. A stronger entrepreneurial spirit and improved investment in knowledge and innovation, and reform of employment systems are key to increasing productivity and opening up new opportunities for growth. Better functioning and more competitive labour, product and capital markets are indispensable to achieve a more flexible economy and increase potential growth. Due regard must also be paid to economic, social, and environmental sustainability concerns to ensure that efforts will produce the expected results in the longer term.

In addition to these broad economic policy guidelines (BEPGs), Member States should fully implement the employment guidelines and the associated recommendations, which are required by the Treaty (Article 128 (2)) to be consistent with the BEPGs.

The general economic policy guidelines in Part I are applicable to all Member States and to the Community. Part I includes a section on the euro area, addressing its specific challenges. Within the overall strategy, key economic policy challenges may differ across Member States due to differences in economic performance, prospects, structures and institutions. Taking due account of them, part II presents country-specific economic policy recommendations. While the new Member States are invited to conduct their economic policies along the lines of these guidelines, the 2004 update of these guidelines will provide the occasion to take a closer look at their situation and particular policy requirements.

2. STRENGTHENING THE EU'S ECONOMY

Economic growth has turned out to be significantly weaker than anticipated. GDP growth remained sluggish in 2002 and short-term indicators suggest that it will continue to do so in 2003. Beyond the recent geopolitical tensions and fading external demand, weak growth stems from an insufficient resilience to shocks. Falling confidence among businesses and consumers reflects these uncertainties.

However, the decline in oil prices, the alleviation of geopolitical tensions following the end of the conflict in Iraq, the recovery in financial markets and improvements in financial conditions reinforce the basis for a growth recovery in the second half of 2003. Yet, the pace of recovery is likely to be affected by still rising unemployment and by weak balance sheets of both financial and non-financial corporations.

Employment growth has been resilient until late 2002, but given that the labour market situation reflects economic developments with a lag, a certain deterioration in employment prospects is likely in 2003. Furthermore, wages have been slow to adapt to low productivity growth.

Headline inflation has recently hovered just above two percent. Core inflation has been decelerating since the second half of 2002, albeit at a slow rate. In this respect, it appears that rigidities still stand in the way of fast adjustments. Looking forward, slowing unit labour costs should lead to a deceleration of inflation to rates below two percent.

Against this background, it is important that economic policies inspire confidence and thereby help to create conditions for stronger domestic demand and job creation on the short term as well as for an expansion of growth potential in the medium-term. In order to effectively support the implementation and monitoring of policies, macroeconomic statistics and analytical tools of the highest quality are required.

2.1. *Growth- and stability-oriented macroeconomic policies*

Macroeconomic policies play a key role in sustaining growth and employment and in preserving price stability. They should aim at supporting a well-balanced growth and the full realisation of current growth potential. They should furthermore aim at establishing the framework conditions that promote adequate levels of saving and investment. In planning for the future, firms and individuals must have confidence that price stability and sound public finances will be maintained. The maintenance of sound macroeconomic conditions depends on the policies pursued by central banks and governments, and the wage developments.

In accordance with their mandate, **monetary authorities pursue price stability**. In line with the Treaty and without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community.

Fiscal policies should continue to be pursued as part of a medium term-oriented, comprehensive and growth-friendly strategy. Member States should contribute through their budgetary policies to stabilising output around a higher and sustainable growth trend, by allowing the full and symmetric play of the automatic stabilisers over the cycle while avoiding excessive deficits and ensuring structural consolidation in order to achieve budget positions close to balance or in surplus in cyclically-adjusted terms. To this end, coordination of budgetary policies should be reinforced in line with the Council report of 7 March 2003 endorsed by the Spring European Council.

When assessing the conformity with the close to balance or in surplus requirement, particular attention shall be paid to country-specific circumstances, in particular to: (i) ensure that a sufficient safety margin is preserved at all times including an allowance for automatic stabilisers to operate fully without breaching the 3 % of GDP reference value, (ii) ensure the long-term sustainability of public finances, and (iii) ensure

the coherence between the evolution and quality of the public finances in the Stability and Convergence programmes and the close to balance or in surplus requirement.

In particular, Member States should:

1. reach or maintain budgetary positions of close to balance or in surplus throughout the economic cycle; countries with deficits exceeding the close to balance or in surplus stability and growth pact requirement must improve their cyclically-adjusted position; countries with excessive deficits need to correct them in line with the stability and growth pact;

2. subject to this, avoid pro-cyclical policies that counteract the symmetric play of the automatic stabilisers over the cycle. This is particularly important when growth conditions become favourable.

Wage developments should contribute to stable macroeconomic conditions and to an employment-friendly policy mix.

Member States should promote the right framework conditions for wage negotiations by social partners. It is important to:

3. ensure that nominal wage increases are consistent with price stability and productivity gains. In particular, labour cost developments should remain moderate in the context of a possible cyclical recovery in productivity or temporary increases in inflation. This would allow companies to increase job-creating investment. Foster the macroeconomic dialogue in a context of productivity-oriented wage policies.

2.2. ***Economic reforms to raise Europe's growth potential***

Structural reforms are essential to increase the EU's growth potential. To yield maximum synergies, they are best implemented in a comprehensive and coordinated way. By introducing more flexibility in the economy, they contribute to macroeconomic stability and to resilience to shocks. Furthermore, structural reforms in different areas, the more so if implemented together, can produce substantial benefits and reduce adjustment costs also in the shorter run when exploiting synergies. For example, additional labour supply triggered by labour market reforms will be taken up more rapidly in the presence of new business opportunities opened up by product and capital market reforms. Conversely, new business opportunities created by product and capital market reforms can only be taken advantage of if appropriately educated and skilled workers are available.

(i) *Towards full employment: more and better jobs*

Human resources remain greatly under-utilised in the EU. This is evidenced by the comparatively low employment rates in the EU as well as low labour productivity growth [the latter is addressed in section 2.2.(ii)]. The main reason why GDP per capita is well below the United States level is that fewer people — in relation to the total population of working age — are in employment, and those that are tend to work fewer hours. Labour market reforms that increase labour supply and make labour markets more adaptable to changing economic conditions are therefore of great importance for the EU economies. Such reforms must **make work pay**. Many people have in fact been encouraged to leave the labour market or to remain inactive, for example through relatively generous or loosely enforced benefit systems, or through incentives to retire early. When they do seek work, they are often faced with the prospect of high marginal effective tax rates, as well as withdrawal of benefits.

Moreover, lack of child care facilities makes it more difficult to take up a job, especially for women. Some, particularly the low-skilled or those living in poorer regions, find themselves **priced out of jobs**, which points to the need both to improve the quality of education and training [as discussed in section (ii)] and to allow wages to better reflect productivity. While overly restrictive labour market regulations benefit established employees, it does so at the expense of those at the margins of the labour market, making it too costly for firms to take on new staff, which are left at greater risk of long-term unemployment. By contrast, relaxing overly restrictive elements of employment protection legislation, better regulation and more flexible work organisation — for example, greater opportunities for part-time work for those who want, and flexible working hours — properly balanced by due security in employment relationships, would make it easier both for people to join the labour force and for firms to take them on. Obstacles and disincentives to labour mobility — both geographical and occupational — also impede the proper functioning of the labour market, leaving ample scope for an improved match between job openings and the human resources available to fill them. In this context the effective integration of migrant workers into the labour market will be crucial.

Creating the conditions for full employment, better quality and productivity at work, greater cohesion and inclusive labour markets, are fundamental to the Lisbon strategy and have become the overarching objectives of the European Employment Strategy. Making better use of human resources is a top priority in the Lisbon strategy. It is reflected in targets established by EU Heads of State and Government for overall, female and older workers' employment rates and in the call for an increase of five years in the effective average age at which people stop working in the EU. Their achievement would mark an important step towards the overall objective of an employment rate of 70 % by 2010. Higher employment rates would directly contribute to higher growth. They are an element of the well established three-pronged strategy for tackling the budgetary implications of ageing populations. To reach these targets, the root causes of high unemployment and low labour force participation in the EU must be tackled. Action **to improve incentives** in order to make work pay, **to facilitate job creation and to improve the efficient functioning of the labour market is important in this respect.**

In pursuing reforms to increase employment, Member States should vigorously implement all the employment guidelines and the recommendations addressed to them, which deal with employment issues in greater detail. In order to contribute to raise Europe's growth potential and to tackle the budgetary implications of ageing populations, Member States should over the coming three years:

4. improve the combined incentive effects of taxes and benefits, reduce high marginal effective tax rates in order to reduce unemployment and poverty traps and increase the return on human capital, reduce tax and benefit disincentives to supply and demand for low-paid labour. Improve the design and administration of benefits to motivate the take up of work, consider the structure of replacement rates, address the level, duration and/or eligibility criteria of benefits, in accordance with the recommendations in the 2003 EPC annual report on structural reforms whilst preserving an adequate level of social protection, and ensure the efficiency of job search assistance for benefit recipients (see also employment guideline 8);

5. ensure that wage bargaining systems allow wages to reflect productivity, taking into account productivity differences across skills and local labour market conditions;

6. while respecting the role of social partners according to national practices, review labour market regulations notably by relaxing overly restrictive employment protection legislation and addressing those relating to employment contracts and employment protection legislation, and promote more adaptable and innovative work organisation (see also employment guideline 3);

7. facilitate labour mobility, both geographical (within as well as across countries) and occupational, especially by promoting the recognition of qualifications and the transfer of social security and pension rights, by eliminating obstacles to mobility related to the housing market, and by promoting lifelong learning (see also employment guidelines 3 and 4);

8. ensure efficient active labour market policies with special attention to people facing the greatest difficulties in the labour market, according to rigorous impact evaluations (see also employment guideline 1 and 7).

(ii) *Towards a competitive and dynamic knowledge-based economy with better jobs: Increasing productivity and business dynamism*

Increasing the EU's growth potential depends not only on job creation but also on giving an additional stimulus to labour productivity and business dynamism. Indeed, in a context of a progressively declining labour force linked to ageing, further productivity increases are indispensable to maintain and increase future living standards. Increasing productivity makes it possible to raise real wages, and gives scope for investing. In public services it attenuates cost pressures and provide a higher level of quality for a given level of funding. To boost productivity it is necessary to fully reap the benefits of the internal market, to cost-effectively invest in skills, knowledge, innovation and organisational change and make broader use of new technologies. At the same time, much stronger business dynamism is needed to improve the competitive position of European firms. Labour productivity gains are highly dependent on increased and more efficient **investment in physical capital** (capital deepening) **and in knowledge and innovation**. Striving for quality at work and improving the overall quality of human resources through investment and higher efficiency of training will contribute to raising human capital and labour productivity levels. Non-discrimination in the access to education and training will also enhance productivity and improve the opportunities to find a job. Job quality as well as measures to increase labour supply and promote active ageing is addressed in detail in the employment guidelines.

Both the public and the private sector will have to contribute if the Lisbon goals are to be achieved. Governments can contribute by spending public money as efficiently as possible, by redirecting public expenditure towards growth-enhancing cost-effective investment and human capital and knowledge subject to overall budgetary constraints, and by seeking a higher leverage of public support on private investment. In particular, investments in key European infrastructures, such as Trans European Networks, are a top priority to be addressed at the EU level. The lion's share of the increase in investment will have to come from the private sector. Policies should therefore aim at improving the **economic framework conditions**, which will encourage businesses to innovate, invest and grow. This implies fostering competition in product and capital markets, ensuring a level playing field for firms in the EU, promoting entrepreneurship and ensuring a high quality regulatory environment, increasing investor confidence, and rewarding investment in knowledge and innovation.

The Internal Market plays an important role in this respect, including financial market integration, as recent studies have shown. In particular the scope of full market opening for boosting growth and employment in the service sector needs to be exploited. The Commission has presented a new and streamlined Internal Market Strategy for the 2003-2005 period with new proposals to exploit the full potential of the Internal Market for growth, job creation and competitiveness.

At the same time, a strong impulse to the long-run potential growth rate of the Union can stem from an increased diffusion of knowledge and innovation across Member States. In this perspective, policies to better integrate national innovation and educational systems can play an important role.

In particular, Member States should over the coming three years:

9. foster competition in goods and services markets, in particular by: (i) increasing the transposition rate of Internal Market directives in line with agreed targets and eliminating remaining barriers (including barriers created through the fiscal system) to cross-border trade and market entry in goods and, especially services markets; (ii) further opening up public procurement; (iii) ensuring effective independence and giving adequate powers and resources to competition and regulatory authorities, (iv) continuing efforts to reduce the overall level of State aid and reorient aid towards horizontal objectives of common Community interest and targeting it to identified market failures; and (v) encouraging market entry and effective competition in network industries while pursuing a greater connectivity of national markets within the enlarged EU and guaranteeing the universality, high-quality and efficiency of services of general interest;

10. accelerate the integration of EU capital markets, in particular by implementing the Risk Capital Action Plan by 2003 and the Financial Services Action Plan by 2005 (2003 for securities markets); ensuring consistent enforcement of EU rules and removing barriers to efficient cross-border clearing and settlement;

11. generate a supportive environment for entrepreneurship and for SMEs to start-up and grow by reducing the administrative burden on business; by simplifying the corporate tax system; by improving and simplifying the regulatory environment, notably entry and exit mechanisms; and by improving the access to finance, in particular venture capital, for small and medium-sized enterprises;

12. agree on and implement measures to strengthen corporate governance, at national and at Community level. Further improve arrangements at national and Community level to deliver efficient cross-sector and cross-border cooperation in financial supervision and financial crisis management;

13. take active steps to promote investment in knowledge, new technologies and innovation and make progress towards the 3 % of GDP objective of total R&D investment by: (i) developing framework conditions conducive to R&D and innovation through further implementation of structural reforms in product, capital and labour markets; (ii) developing the institutional framework and intellectual property protection, in particular by realising an affordable and legally-certain Community patent; (iii) promoting networking and knowledge transfer through science-industry links and researcher mobility; (iv) promoting access and use of ICT in line with the e-Europe 2005 Action Plan; (v) facilitating the development of the Union's satellite navigation system Galileo; and (vi) improving the quality and efficiency of education and training systems, including lifelong learning and active labour market policies, in order to respond adequately to changing skills requirements, thereby maintaining and upgrading the human capital base (see also employment guideline 4);

14. enhance the contribution of the public sector to growth by: (i) redirecting, i.e. while respecting overall budgetary constraints, public expenditure towards growth-enhancing cost-effective investment in physical and human capital and knowledge; (ii) increasing the efficiency of the public sector, *inter alia*, by introducing mechanisms to assess the relationship between public funds and policy objectives and to help control spending; (iii) establishing an appropriate framework for joint public-private initiatives, adopting new technologies, outsourcing, competition in public procurement; (iv) ensuring that tax structures strengthen the growth potential by promoting employment creation and investment.

2.3. ***Strengthening sustainability***

Growth will only prove to be sustainable if due attention is being paid to issues of economic, social, and environmental sustainability and to the synergies between these aspects. Carrying out impact assessments and cost-benefit analysis of proposed legislation will allow synergies and trade-offs between economic, environmental and social objectives to be identified and assessed systematically. Where possible, flexible, market-based solutions that achieve environmental and social goals, should be preferred.

(i) *Economic sustainability: Ensuring the long-run sustainability of public finances*

Ageing populations imply important challenges. Rising old age dependency ratios will put increasing pressure on public finances. Rising expenditure on, notably, public pensions and health care, will have to be shouldered mainly by a shrinking working age population. The need to ensure the long-term sustainability of public finances has been underlined by the Lisbon, Stockholm and Barcelona European Councils. To address the economic and budgetary consequences of ageing, the Stockholm European Council decided that a **three-pronged strategy** should be followed, focusing on increasing employment rates [see section 2.2(i)], on the reduction of public debt, and on reforming pension and health care systems. In this context, the impact of immigration needs to be further examined.

Sustainability concerns should be explicitly taken into account when assessing the budget positions of Member States and therefore greater weight must be attached over the coming years to **government debt** ratios in the budgetary surveillance process. If debt reduction is to make a noticeable contribution towards meeting the budgetary cost of ageing populations, then reaching the required balanced budget position and in some cases running surpluses is essential; this should be part of an ambitious three-pronged strategy to meet the long-term budgetary consequences of ageing.

Reforms of pension systems should be forcefully pursued in line with the broad common goals agreed by the Gothenburg and Laeken Councils. This should be done with a view to safeguarding the adequacy of pensions, ensuring the financial sustainability of pension systems and modernising pension systems in response to changing needs of the economy, society and individuals. The Joint Report on Member States' pension strategies, welcomed by the Brussels Spring European Council in March 2003, underlines that ensuring long-term financial sustainability is not only important in its own right but is also a necessary precondition for an adequate provision of pensions in the future. It concludes that the momentum behind the reform process to secure the sustainability of adequate pensions must be maintained, including more wide-ranging and ambitious efforts. To address the budgetary impact of ageing in a timely manner, full use should be made of the **current window of opportunity** before the effects of ageing are felt more forcefully.

In particular, Member States should over the coming three years:

15. ensure a further decline in government debt ratios; Member States still having government debt ratios above the 60 % of GDP reference value, should in the first instance ensure a satisfactory pace of government debt reduction towards that value; other Member States should ensure a sufficient reduction in the debt ratio to further strengthen public finance in view of the costs of ageing, including higher age-related spending;

16. design, introduce and effectively implement reforms of pension systems. Encourage longer working lives and increase the effective retirement age by cost-effectively modifying incentives embedded in pension and tax and benefit systems that encourage early withdrawal from the labour market and by restricting access to early retirement schemes. Make the pension system cope better with expected demographic developments and further increases in life expectancy, notably by better linking benefits to contributions. Introduce elements of funding and improve, where necessary, access to supplementary pension schemes, including funded schemes, and ensure the safety of such benefits through appropriate regulatory frameworks and through sound management, so that private and public funded pension schemes can provide pensions with the required efficiency, affordability, portability and security, while increasing the link between contributions and benefits. Adapt pension systems to more flexible employment and career patterns as well as to individual needs, including the portability of pension benefits while at the same time ensure that pension systems stimulate labour supply (see also employment guidelines 5 and 8).

Just like the Member States, the Community should apply strict budgetary discipline. This must be applied to all categories of the Financial Perspectives, while respecting the inter-institutional agreement on budget discipline and the improvement of the budget procedure.

(ii) *Social sustainability: Contributing to economic and social cohesion*

The Lisbon Strategy will only be successful and be able to attract continued and widespread support for necessary structural reforms if it contributes to improving opportunities for all. Sound economic policies make an important contribution to economic and social cohesion: first, because jobs are the best protection against poverty and social exclusion, by improving the conditions for stronger job creation, especially for people with relatively low skill levels and for those living in regions that lag behind; second, by creating the conditions for enhanced growth and investment and thereby facilitating regional catching up (while poorer Member States catch up with the rest, differences in economic development remain, and these will widen significantly after enlargement); and third, by contributing to a more productive economy with appropriate social conditions and equal treatment, thereby also generating resources for the necessary accompanying social, educational and regional development policies to facilitate the transformation of the economy and to reduce poverty and social exclusion. Inclusive labour markets as a contribution to cohesive societies are further addressed in the Employment Guidelines and in the Social Inclusion Process.

Catching up and employment creation depend on sound framework conditions for private sector activity and investment. This implies inter alia a competitive environment for business, a stable macro economy and adequate supply of input factors, including skilled labour and technology. Thus successful implementation of the policies set out in the various parts of this document will help to create such conditions. In particular, measures to improve the functioning of labour markets and allowing actual wages to properly reflect productivity differences across skills and local labour market conditions are important. Furthermore, there is a need for targeted policy actions aimed at ensuring the availability of basic infrastructure of a sufficient quality, and at improving and reorienting education efforts and life long learning in order to raise the skills and adaptability of the labour force.

In this context, it should be recalled that the EU contributes importantly to investment in regions lagging behind through the cohesion and structural funds as well as the European Investment Bank. Member States should provide an efficient level of public investment across a wide range of education and training, and undertake reforms to improve educational standards and to encourage sustained investment from enterprises and individuals.

In particular, Member States should over the coming three years:

17. whilst ensuring an adequate level of social protection, take steps to modernise social protection systems and to fight poverty and exclusion with a view to supporting the broad Lisbon objectives, notably on employment, in order to achieve an inclusive labour market and a more cohesive society for all (see also guideline 4);

18. improve the functioning of markets so that they are conducive to private investment in regions lagging behind, particularly by taking steps to allow actual wages to reflect productivity taking into account differences in skills and local labour market conditions (see also guideline 5);

19. ensure that public support, including from EU sources, in regions lagging behind is focused on investment in human and knowledge capital, as well as adequate infrastructure, and that investment programmes, including those supported by EU sources, are designed and administered efficiently so as to maximise their impact (see also guideline 13). In this context, strengthen the operational cooperation between the Commission and the European Investment Bank.

(iii) *Environmental sustainability: Promoting efficient management of natural resources*

To contribute to an increase in the well-being of current and future citizens, future **economic growth must take place alongside environmental sustainability**. To promote an efficient use of natural resources, their prices should reflect their costs to society, including the external costs related to the environmental damage caused during their extraction, use and final disposal. This will encourage adaptation and innovative solutions by firms, citizens and Member States. In this way, environmental technologies can contribute to growth and employment.

However, a common feature of many natural resources (for example, clean air and water) is that there are no clearly defined ownership rights. In such cases, even while it is in the interest of society as a whole that the resource is managed in a sustainable way, no one individual has an incentive to do so.

Thus there is a need for government action to successfully de-couple economic growth from environmental degradation and consumption of natural resources. Environmental sustainability will require a mix of regulatory and market-based instruments. **The environmental costs of economic activity should gradually be priced in. The use of scarce natural resources should be paid for. The 'polluter pays principle' should be systematically applied**. However, any government intervention must be proportionate and well-targeted, and needs to take into account factors such as distributional effects and business competitiveness.

In particular, Member States should over the coming three years:

20. reduce sectoral subsidies, tax exemptions and other incentives that have a negative environmental impact and are harmful for sustainable development. Ensure, *inter alia* through the use of taxes and charges, that pricing of the extraction, the use and, if applicable, the discharge of natural resources, such as water, adequately reflects their scarcity and all resulting environmental damage;

21. reduce subsidies to non-renewable energy. Promote market instruments, further broaden the coverage, and ensure appropriate differentiation of energy taxation to deliver in a cost-effective manner a more sustainable mix and level of energy consumption, with a view to promote energy efficiency, to increase at the same time the proportion of renewable energy and further enhance competition and network interconnection in energy markets;

22. adjust the system of transport taxes, charges and subsidies to better reflect environmental damage and social costs due to transport, thereby reducing distortions in the demand for transport services and the choice of transport modes, and increase competition, e.g. through accelerated regulated market opening, in transport modes such as freight railways to make them more competitive;

23. renew efforts to meet their commitments under the Kyoto protocol, which is particularly important for those Member States that at present are not on track to meet their commitments. To this end, implement the EC greenhouse gas emissions trading scheme. Prepare new and immediately implement existing policies and measures for those sectors not covered by allowance trading and set up systems to report on those policies and measures and their prospective effects on emissions. Take measures to reach the targets set by subsequent European Councils, notably on energy efficiency, renewable energy and bio-fuels.

3. EURO AREA SPECIFIC CHALLENGES

Growth in the euro area, which still appeared robust in 2000, slowed down when the global economy decelerated in a context of global uncertainties and falls in asset prices: domestic demand did not provide a sufficient buffer to the impact of economic shocks. This became particularly evident in 2002 when

domestic demand was not sufficiently robust to take over from the initial stimulus from the external side. In this context, growth has been below potential. Moreover, the current level of potential growth in the euro area limits the scope for a sustainable high rate of economic growth.

Economic growth in the euro area is expected to gradually recover to potential after the effects of recent shocks fade away. The economic outlook is conditioned on a number of assumptions on whether, when and what kind of risks materialise. Positive factors are already in evidence including a fall in oil prices and inflation. However, forecasts assume growth to remain still very weak in 2003, with a recovery only gathering strength in the second half of 2003 and accelerating in 2004.

The challenges facing the euro area are to:

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

Strengthen potential growth

Structural reforms are essential in order to meet the challenges for the euro area, in particular to reinforce confidence and increase growth potential. By introducing more flexibility in the economy, they contribute to macroeconomic stability. Furthermore, structural reforms in different areas, if implemented together, can produce substantial benefits and reduce adjustment costs.

Cater for balanced macroeconomic policies

In the short-run, the policy-mix in the euro area need to support economic recovery while at the same time safeguarding long-term sustainability and stability. At the current juncture, it is important that the policy mix underpins confidence among consumers and investors which implies remaining committed to medium-term stability.

In the medium term, budgetary policy has to ensure a fiscal position consistent with the need to prepare for the impact of ageing populations on the one hand and to accomplish a composition of public expenditure and revenues that fosters economic growth on the other.

In accordance with the Treaty mandate, the ESCB pursues price stability and, without prejudice to the price stability objective, support the general economic policies in the Community.

Monitoring inflation differences

Inflation differences between Member States are a matter of fact in any monetary union. Through them, the necessary changes in relative prices between countries take place when the exchange rate is not available. Recent inflation dispersion in the euro area largely reflects the diversity of national economies and domestic growth rates.

However, certain inflation differences may be due to the malfunctioning of product and labour markets or inappropriate policies. Therefore, inflation differences need to be monitored and, when undesirable, be addressed by Member States through using the levers available to them.

Strengthen economic policy coordination

The euro, the euro area's external balance and price stability in the euro area have become common goods. It implies the need both for stronger macroeconomic and structural policy coordination in the euro area to improve the euro area's resilience to shocks, and improve its growth potential and performance.

Preserving macroeconomic stability and policies conducive to non-inflationary growth relies on a coherent formulation of macroeconomic policies. While respecting their mandate and independence, the relevant policy actors must ensure the compatibility of their objectives and aim for a common assessment of the underlying economic situation. Budgetary authorities should safeguard the credibility of the rules-based framework for fiscal policy by implementing it in a transparent and foreseeable manner. A stronger focus should be put on implementation. Member States should be open to peer pressure, benchmarking and the provision of best practices also in the area of structural policies.

To foster harmonious economic developments, it is essential to closely coordinate economic policies among euro area policy actors and to have a continuous and fruitful dialogue. The involvement of the social partners through the macroeconomic dialogue also plays an important role. At international level, the growing importance of the Euro area also calls for higher visibility and a strengthening of the relevant coordination mechanisms such that it speaks with a voice commensurate with its economic and financial weight in the different fora.

Specific recommendations to the euro area

Meeting the challenges outlined above requires broad structural reforms as they are laid down in the general guidelines (GL) in part I of the broad economic policy guidelines.

Policy actors at national level are recommended to:

24. contribute to a policy-mix that is compatible with price stability and the need to enhance confidence among business and consumers in the short run as well as with economic growth close to potential in the medium term;

25. maintain budgetary positions of close to balance or in surplus throughout the economic cycle in cyclically-adjusted terms, and as long as this has not yet been achieved, take all the necessary measures to ensure an annual improvement in the cyclically-adjusted budget position of at least 0,5 % of GDP. Countries with excessive deficits need to correct them according to the Treaty;

26. analyse the causes of inflation differences to identify instances when they are undesirable, with a view to Member States addressing them through using the levers available to them;

27. deepen the analysis of and discussion on economic developments and policy requirements, including the policy-mix and exchange information where appropriate, focus more on implementation, and strengthen the external representation of the euro area in terms of communication and visibility;

28. improve the efficiency of the existing coordination procedures in the area of structural reforms that aim at strengthening the euro area's growth potential and its resilience to shocks. Intensifying structural reform will also help to raise potential growth.

II. COUNTRY-SPECIFIC ECONOMIC POLICY GUIDELINES

1. BELGIUM

Robust economic performance was registered in Belgium in recent years. However, the general economic downturn had a sharp impact on the economy of Belgium, with real GDP growth decelerating progressively from 3,7 % in 2000 to 0,7 % in 2002. An upturn in activity is foreseen in 2003, strengthening in the forthcoming years, potential output being estimated at around 2 %. Belgium made considerable progress in budgetary adjustment in the past years. However, the current unfavourable macroeconomic context requires additional efforts to implement the commitments to budgetary consolidation.

Recently, the path of reduction of the Government debt ratio has decelerated due to lower economic growth and also the negative impact of financial operations. Yet, in particular in view of the future budgetary costs of an ageing population, fast reduction in the Government debt is of central importance for Belgium. Improvement in the functioning of the labour market, a necessity in itself, could also make a contribution to budgetary adjustment. Moreover, product-market reforms are needed in order to improve competitiveness and productivity. The challenges facing Belgium are to:

- ensure the continuation of the budgetary adjustment in the forthcoming years, in particular in view of ensuring the long-term sustainability of public finances in the face of population ageing,
- increase the low participation and employment rates, especially for older workers and women, and improve incentives to work,
- enhance competition in certain services sectors and continue to increase the efficiency of the public administration and to improve the business environment.

Ensure the continuation of the budgetary adjustment in the forthcoming years, in particular in view of ensuring the long-term sustainability of public finances in the face of population ageing

The challenge of reducing the still high debt ratio (of 105,4 % of GDP in 2002) and to prepare for the budgetary costs of an ageing population, require sustained sound budgetary policies over the long run. The strategy followed by Belgium, in particular, the policy of maintaining high primary surpluses, is expected to provide leeway to cover age-related budgetary costs. However, such an effort has to be sustained over the long run and a failure to maintain the primary surpluses at a sufficiently high level might mean that the risk of unsustainable public finances could not be avoided.

In coming years, budgetary policy will face the challenge of maintaining control of government primary expenditure, limiting its increase in real terms, while providing for the costs of needed reforms and other budgetary objectives. In this context, budgetary efforts aimed at reducing the government debt ratio need to be supported by policies to improve labour force participation and to raise the still low employment rates.

Increase the low participation and employment rates, especially for older workers and women, and improve incentives to work

The employment rate, which has been growing steadily over the second half of the nineties, was still at 59,9 %, four percentage points below the EU average in 2001, and far away from the EU employment

targets. The employment rate of older workers (55 to 64 years) was only 25,1 % in 2001, the lowest rate in the European Union and about 13,5 percentage points below the EU average. It is unlikely that the measures taken so far will suffice to reach the EU target for 2010. The challenges posed by an ageing population suggest a need for measures aimed at mobilising the non-occupied potential labour force, thereby increasing employment and participation rates.

Notwithstanding recent measures to address the problem of benefit dependency and to reduce the risk of 'unemployment traps', there is still a sizeable number of working age benefit recipients not in employment. The work disincentives of the current unemployment benefit schemes call for their further review in order to tackle the still high share of long-term unemployment, which remains a major structural problem. Linguistic barriers, high housing registration costs, and wage compression contribute to the persistence of disparities between geographical areas and reduce incentives to mobility.

Enhance competition in certain services sectors and continue to increase the efficiency of the public administration and to improve the business environment

Competition remains limited in most network industries and in local services, leading to high consumer prices for example for local phone calls or electricity. In network industries, difficulties for competitors to access the networks, physical bottlenecks, and the historical links with public authorities contribute to maintain the market power of incumbents. In local services, the links between local public authorities and private partners, notably in inter-municipal trusts, still lack transparency. In spite of larger institutional powers, the competition authority remains understaffed and the effective independence of all sectoral regulators is not yet secured.

In the recent past, measures to reduce the administrative burden for companies and to improve the efficiency of public administration are helping to create a more business-friendly environment. In particular, plans have been carried out to reduce the costs and administrative procedures involved in creating a company and the 'Copernicus' plan aims at modernising the federal administration. The impact of these plans has still to fully materialise.

Country specific recommendations to Belgium

Meeting the challenges outlined above requires broad structural reforms as they are laid down in the general guidelines (GL) in part I of the broad economic policy guidelines.

In order to ensure the continuation of the budgetary adjustment in the forthcoming years, in particular in view of ensuring the long-term sustainability of public finances in the face of population ageing, Belgium is recommended to:

1. ensure that the government debt ratio is kept on a sustained declining trend at a satisfactory pace by maintaining high primary surpluses (GL 15);

2. limit the real expenditure increase in Entity I (Federal Government and social security) to 1,5 % and allocate proceeds stemming from higher than expected economic growth to improve the budgetary position as a matter of priority; and

3. strengthen the existing strategy in order to prepare for the budgetary implications of population ageing: in particular by reducing the debt level, better addressing the low effective retirement age, pursuing the reform of the pension systems, and strengthening efforts to finance the Ageing Fund (GL 16 and E-REC 2).

Belgium should also vigorously implement all the employment recommendations (E-REC), which deal with employment issues in greater detail. In order to increase growth potential, ensure the long-term sustainability of public finances, and address the effects of ageing populations, it is especially important for Belgium to increase the low participation and employment rates, especially for older workers and women, and improve incentives to work. Belgium is in particular recommended to:

4. take further steps to reinforce measures to postpone retirement from the labour force, in particular by combining a removal of incentives to early retirement (GL 16) with enhanced prevention and activation measures for older workers; and

5. continue progress in making work pay by eliminating the major distortions to work incentives arising from the interaction of the tax and benefit systems (GL 4 and E-REC 3).

In order to enhance competition in certain services sectors and continue to increase the efficiency of the public administration and to improve the business environment, Belgium is recommended to (in line with GL 9 to 14):

6. take measures to enhance effective competition in network industries and in local services (in line with GL 9); and

7. improve public administration in the context of the ongoing reform and pursue the reduction of administrative burden for companies (GL 11).

2. DENMARK

The Danish economy has for some years now been operating close to potential growth rates with real growth rates averaging $2^1/_2$ % in the last 10 years. In this period the economy benefited from a large reduction in unemployment from over 12 % of the labour force to now around 5 % — a large part of this reduction can be viewed as being structural. As it will not be possible to replicate this fall in unemployment in coming years and as demographic changes result in lower growth in working age population, potential growth rates are expected to be reduced to around 2 %. The large reduction in unemployment in the last decade also had a positive impact on public finances, where a surplus has been achieved every year since 1997.

For the Danish economy to continue to be in good shape, despite the lower potential growth rates, it is necessary to address a number of longer term and structural issues. In order to maintain a sustainable fiscal policy it is necessary to continue to achieve solid surpluses on public finances. To achieve this, without triggering a need for a fiscal tightening at some later stage, it is necessary to increase the labour supply, both as a means to reduce expenditures and to increase tax revenues. Furthermore, the price level continues to be among the highest in the EU — partly reflecting a lack of competition in certain sectors and there is room for improving efficiency in the public sector. The challenges facing Denmark are to:

- ensure an adequate labour supply in view of the ageing of the population,
- enhance competition in certain sectors and improve the efficiency of the public sector.

Ensure an adequate labour supply in view of the ageing of the population

Employment rates are already high in Denmark, and well beyond the Lisbon targets for EU as a whole, including for women and older workers. However, in order to maintain the sustainability of the current fiscal policy strategy, to prepare for the impact of the ageing population on public finances and to safeguard the growth potential, it is necessary to increase labour force participation rates and to reduce unemployment rates further, and beyond what already implemented reforms are expected to generate. These increases will contribute to achieving the government's targets of surpluses of $1^1/_2$-$2^1/_2$ % of GDP as a means to prepare for the impact of ageing on public finances.

Much has already been done in the field of active labour market policies, especially with regard to the right to and obligation of job activation. Measures have also been taken within benefit systems and retirement schemes. Furthermore, a tax reform has been announced recently for 2004-2007 with the purpose of lowering taxes on earned income, which should also contribute to an increase in the labour supply. However, further reforms would be needed to ensure a marked increase in the already high labour force participation and employment rates. Sources of potential labour supply increases could include better integration of immigrants in the labour market, a faster channelling of students through the education system, and efforts to improve labour market attachment for senior workers. Further improvement in the number of people in the labour force or in the number of hours worked per person could be encouraged via additional tax and benefit reforms, in particular by reducing the still relatively high marginal tax rates, or tightening the conditions for early retirement or a combination of both. Estimates show that reductions of different kinds of tax rates may have a marked impact on labour supply. However, considerations concerning additional tax reforms should take into account the framework of sound public finances. With regard to increasing the retirement age, consideration could be given to further improve incentives to continue to work instead of withdrawing early from the work force by entering into early retirement. The instruments chosen should respect the reasoning behind the focus on labour supply, namely sustainable public finances. In order to achieve the necessary surpluses on public finances it is not only necessary to increase the labour supply, strict expenditure control also has to be continued in order to prevent slippage, which may jeopardise the targets.

Enhance competition in certain sectors and improve the efficiency of the public sector

Continuing efforts to enhance competition could contribute to lower the Danish price level, which is the highest in the EU, and to improve productivity, which is around the EU average. Competition is weak in a number of industries, such as for instance the energy sector, housing, construction, beverage cans and a number of non-tradable services. The full liberalisation of the energy market could also contribute to better competition and lower prices throughout the economy.

The Danish public sector is among the largest in the EU. Substantial efforts have been made to improve its efficiency and Denmark has a rate of openly advertised public procurement above the EU average. However, public entities are still sole producers in many areas of public services and it remains to be seen to what extent recent reforms to extend consumer choice for public services will increase competition from the private sector. Furthermore, efficiency could be increased in the education sector, where the OECD PISA study shows relatively poor results for Denmark, despite high education expenditure.

Country specific recommendations to Denmark

Meeting the challenges outlined above requires broad structural reforms as they are laid down in the general guidelines (GL) in part I of the broad economic policy guidelines.

Denmark should also vigorously implement all the employment recommendations (E-REC), which deal with employment issues in greater detail. In order to prepare for the impact of the ageing population on public finances and to safeguard the growth potential, Denmark is in particular recommended to:

1. continue efforts to increase labour supply notably by efforts to make work pay by increasing incentives to join and remain in the labour force and to postpone retirement, in particular by ensuring the implementation of the tax reform and by considering additional steps to tighten eligibility rules and reduce marginal taxes within a framework of sound public finances (GL 4 and E-RECs 1 and 3); and

2. ensure expenditure control at all levels of government so that the multi-annual targets for public consumption growth are respected (GL 14).

In order to enhance competition in certain sectors and improve the efficiency of the public sector, Denmark is recommended to (in line with GL 9 to 14):

3. step up efforts to enforce competition in sectors where competition is inadequate (GL 9); and

4. continue efforts to increase the efficiency of the public sector, inter alia by improving framework conditions for increased competition, promoting the benchmarking of public sector efficiency, and by increasing public tendering (GL 11).

3. GERMANY

Since the boom caused by unification, Germany has experienced lower growth rates since the mid-nineties, both in comparison with other European countries and with its own historical rates. Stagnation, partly linked to the costs and effects of unification, has gradually become more and more entrenched. In 2003, GDP growth is very likely to remain below 1 % for the third year in a row. Germany's relatively low growth potential of around $1^1/_2$ % (compared with one of $2^1/_4$ % for the rest of the EU) is the result of structural adjustments in the aftermath of reunification and rigidities in the labour market and regulatory burdens, and also of a very low population growth. While low growth is a problem in itself, it spills over into the field of public finances, where tax and social security revenue shortfalls have led to Germany's breaching of the Treaty's deficit criterion. At the same time, the approach chosen to correct the excessive deficit — to a large extent via increases in taxes and social security contributions — may hamper short-term growth prospects. However, in a parliamentary speech on 14 March Chancellor Schröder outlined elements of a broad-based reform agenda, which would constitute important steps towards solving Germany's structural problems.

The solution to the difficult state of public finances cannot be found independently of addressing the root causes of the low growth and vice versa. Far-reaching reforms are necessary, because the social security systems are not sufficiently equipped to dealing with the consequences of population ageing. It is therefore imperative that four key challenges be addressed. The first two are mainly remedies to raise the low economic growth potential, while the latter two address the sustainability of public finances. The challenges facing Germany are to:

- promote job creation and adaptability and mobilise the unutilised employment potential,
- increase productivity through improvements in the business environment and the efficiency of the education system,
- reduce rapidly the general government deficit to below 3 % of GDP and keep government finances on a steady consolidation path,
- secure the long-term viability of pension and health-care systems.

Promote job creation and adaptability and mobilise the unutilised employment potential

The overall employment rate in Germany is close to the EU target of 67 % for 2005. The employment rate for women already exceeds the intermediate EU target of 57 % for 2005, whereas for older workers it remains very low, even below the level reached in 1997. Germany's good record in employing young people contrasts with a severe lack of job opportunities for low-skilled workers, elderly workers, and for people living in disadvantaged regions, notably the East. Considering the large job deficit in the eastern Länder, there is a risk that regional disparities on the labour market may widen further. Employing the aforementioned groups would evidently provide a substantial growth impulse, as well as strengthening public finances. Three structural factors appear most important in the labour market: first, Germany suffers from severe unemployment and inactivity traps, in particular for low wage earners; but the recent introduction of the 'Gleitzone' is — amongst others — an important measure to increase the attractiveness of low paid work. Further tax and benefit-reforms should follow. The recent strengthening of benefit sanctions has triggered higher transitions from unemployment to inactivity, but the effect on incentives for active job search, including sectoral and regional mobility is too early to assess. Second, labour costs of low-skilled workers or people in depressed regions risk exceeding their productivity levels due to the

application of coordinated tariff wages (Flächentarifvertrag). However, Social Partners have the possibility to account for regional or sector-specific differences and to include opening-clauses in the contracts. Indeed, sector-specific wage contracts legally bind companies to the agreed rules if the company is a member of the respective employers' association or the agreement has been declared generally applicable by the government. Reduced wages for trial periods of new job entrants, or for disadvantaged regions, are not only impeded by wage contracts but also by the so-called 'Günstigkeitsprinzip'. Where opening clauses exist, they are seldom applied, particularly so in the West. Third, reintegration of unemployed workers is also made difficult by inefficiencies of large-scale active labour market programmes (ALMPs) and insufficient targeting of such measures. It is still too early to see the effects of recent efforts to improve the evaluation of ALMPs.

Increase productivity through improvements in the business environment and the efficiency of the education system

Low labour input growth is accompanied by a parallel decline in productivity growth and business investment in recent years, which may be associated with a still high regulatory burden and remaining barriers to competition. Although considerable progress has been made in the context of the Hartz reform, labour markets in particular remain heavily regulated. Employment protection legislation and rules controlling entry into crafts and liberal professions are under review. In addition, there is the complexity of parts of the tax code, although the Government continues to simplify the code. Finally, legal restrictions unnecessarily hinder competition in retailing, energy network access fees remain relatively high and subject to ex post control, and there is little evidence of an opening up of public procurement.

With the prospect of a diminishing labour force, the level of qualification is all the more important if Germany is to raise its productivity in order to maintain its living standards. The PISA-OECD study highlighted the relatively poor performance of German secondary schools. In addition, the sometimes rather long university study times are a long-standing problem. Reforms of the education system also constitute an important element for tackling unemployment because the low skilled make up a large share of the unemployed.

Reduce rapidly the general government deficit to below 3 % of GDP and keep Government finances on a steady consolidation path

The 2002 general Government deficit was 3,6 % of GDP, clearly exceeding the respective Treaty criterion. On 21 January 2003, the Ecofin-Council had already decided that an excessive deficit existed in Germany and recommended to the German authorities to implement measures amounting to one percentage point of GDP in 2003 and to bring the excessive deficit to an end by 2004 at the latest. Budget consolidation would also contribute to improving the general business climate and hence increase Germany's growth potential. However, without additional structural reforms to raise Germany's low growth potential, a steady decline in the debt ratio and compliance with the proclaimed target of a close to balance budgetary position in 2006 seems unlikely. Germany was asked by the Council, therefore, to implement urgent reforms, not only in the labour market, but also in the social security and benefit systems in general, and to reduce the regulatory burden on the economy.

Secure the long-term viability of pension and health-care systems

Germany's social security systems are financed mainly on a pay-as-you-go basis. As a consequence, pension and health care systems will have difficulties in coping with the problem of an ageing population. If present rules remain unchanged, social security contributions, already among the highest in Europe, would have to rise substantially over the next decades. This would exacerbate the burden caused by high unemployment and depress growth even further. First steps by the German Government towards a

privately funded pension system (Riester-Rente) have been taken, and 15 % of the employees have made use of this new possibility so far. Further efforts are needed to ensure the long-term financial sustainability in the context of the ongoing process to modernise and adapt the pension system to changing circumstances. The government's initiative to review the financing and further development of social security schemes with the help of an independent expert group is therefore welcome.

The health care system has also come under increasing strain in recent years, mainly due to a sluggish development of revenues, but also to insufficient cost controls and the absence of economic incentives for cost savings. Currently, a reorientation of the health care system is under discussion. The government aims at ensuring the financial sustainability of the health care system, inter alia by strengthening competitive elements while focussing more on the quality of the health care provided.

The concern about long-term sustainability of public finances is all the more pressing as Germany's debt-to-GDP ratio remains above the 60 % threshold, and where a clear downward trend has not yet been established.

Country specific recommendations to Germany

Meeting the challenges outlined above requires broad structural reforms as they are laid down in the general guidelines (GL) in part I of the broad economic policy guidelines.

Germany should also vigorously implement all the employment recommendations (E-REC), which deal with employment issues in greater detail. In order to increase growth potential, ensure the long-term sustainability of public finances, address the effects of ageing populations and reduce regional disparities, it is especially important for Germany to promote job creation and adaptability and mobilise the unutilised employment potential. Germany is in particular recommended to:

1. continue to reform the tax-benefit system (GL 4 and E-REC 6), in order to ensure sufficient incentives to take up work or to move into a higher income bracket, and firmly enforce the conditionality of benefits upon active job search;

2. take measures to ensure that wages reflect better productivity differences across skills and regions (GL 5), notably by reviewing the Günstigkeitsprinzip, allowing temporarily lower payments for job starters; and

3. carry forward the reforms to improve the efficiency of ALMPs, in particular of job search assistance. Further reform ALMPs according to cost-effectiveness criteria and target them better towards those persons most prone to the risk of long-term unemployment (GL 8, 13 iv and E-REC 1).

In order to increase productivity through improvements in the business environment and the efficiency of the education system, Germany is recommended to (in line with GL 9 to 14):

4. encourage businesses to invest and grow by creating a more competitive environment (GL 9) and by further reducing the regulatory and administrative burden (GL 11), *inter alia*, by lowering the effective degree of employment protection (GL 6); and

5. carry out further reforms contributing to improved educational achievements and the elimination of persistent skill shortages (GL 13).

In order reduce rapidly the general government deficit to below 3 % of GDP and keep government finances on a steady consolidation path, Germany is recommended to:

6. ensure a rigorous budget execution and implement the announced or compensatory measures for 2003 amounting to 1 % of GDP and put an end to the present excessive deficit situation by 2004 at the latest (GL 1); and

7. lower the cyclically-adjusted deficit by at least one percentage point of GDP between the end of 2003 and 2005.

In order to secure the long-term viability of pension and health-care systems, Germany is recommended to:

8. promote the take-up of supplementary pension schemes and strengthen incentives for later retirement, (GL 16); and

9. increase the efficiency in the health care sector by introducing economic incentives for health care providers and recipients.

4. GREECE

In 2002, the Greek economy continued to expand at a high rate, despite the adverse international economic conditions. Real GDP growth is expected to remain well above the EU average, reaching 3,6 % in 2003 (slightly above the potential growth rate of around 3,5 %). Economic activity has been boosted by private and public investments, mainly through the preparation for the Olympic games and the third Community Support Framework. However, in order to exceed or remain at its potential level after 2004 further structural reforms are needed. Moreover, high growth rates and rising costs may create further price pressures. In spite of the strong growth and falling interest rates, the government debt ratio has not been reduced significantly. In fact, while the debt ratio declined at a slow pace in the 1997-1999, it increased in 2000-2001 due to the reclassification of large financial operations previously excluded from budgetary accounts.

The situation in the labour market is improving at a very slow pace. Notwithstanding the strong job creation, employment growth is not satisfactory and unemployment, although it fell below 10 % of the labour force in 2002, remained at a high level. The interplay of rigidities in labour and product markets and the late development of knowledge-based society, due in particular to the low level of investment in human capital and in research, are impeding the increase in labour productivity to levels that would accelerate the catching-up process.

Greece needs to further consolidate public finances in order to reduce the high government debt ratio at a satisfactory pace. Structural problems in labour and product markets must be addressed in order to reduce the high unemployment rate, improve productivity and enhance the efficient functioning of the economy. The challenges facing Greece are to:

- ensure the long-term sustainability of public finances in the face of population ageing, in particular in view of the high government debt ratio,
- increase the low level of productivity, which is associated with problems in the functioning of the labour and product markets, low investment in human capital, and the late development of the knowledge-based society,
- reduce the high rate of structural unemployment, and increase employment rates, particularly for women.

Ensure the long-term sustainability of public finances in the face of population ageing in particular in view of the high government debt ratio

Despite the budgetary adjustments and the improvement in Government balances achieved in previous years, the debt ratio did not decline in line with GDP growth and budget deficit developments. In fact, the debt ratio increased in 2000 and 2001, after the revisions required by Eurostat, and stood at 105,3 % of GDP in 2002. The large financial operations partly outweighed the positive impact of the primary surplus on Government debt. The primary surplus is expected to have risen at a slower pace in 2002, while the Government deficit is estimated to be equal to 1,1 % of GDP compared to 1,2 % in 2001. The high growth rates of output constitute a solid base for further improving government balances and turning the budget deficit into a surplus. Limiting public consumption spending in order to free resources for productive uses and containing the high debt ratio are of paramount importance. The high debt ratio, if not controlled, may put at risk the sustainability of public finances in the longer run when financial pressures stemming from the ageing population are expected to arise. Despite the efforts undertaken in the 2002 pension reform, the still-large projected increase in public spending on pensions (from a high starting position) suggests that further efforts are required.

Increase the low level of productivity, which is associated with problems in the functioning of the labour and product markets, low investment in human capital, and the late development of the knowledge-based society

The level of labour productivity has been rising strongly in recent years, but it still remains the second lowest in the EU. This can be explained by low levels of investment in R&D, the still low — albeit growing — level of ICT diffusion, low levels of educational attainment of the population and the resulting lack of skilled workers. In addition, the large percentage of small and micro domestic firms, which is partially due to distortions created, for example, by labour market legislation and by taxation, contributes to low investment in R&D and innovation.

A better business environment is also key to improving the efficiency of product markets. First, competition in certain network industries is still limited. For example, in the electricity and gas sectors, the vertically integrated incumbents continue to dominate the markets. Second, despite recent measures to simplify the regulatory environment and the taxation system, business dynamism continues to be hindered by complex procedures and a lack of efficiency of public administration. Third, the transposition rate of internal market directives is the second lowest in the EU.

Reduce the high rate of structural unemployment, and increase employment rates, particularly for women

Greece's overall employment rate is considerably below the targets set by the European Council, in particular for women. Unemployment fell for a third consecutive year in 2002, but remains well above the EU average, the unemployment rate for women being more than double the rate for men, and youth unemployment remaining very high. Labour market rigidities still hamper the more flexible functioning of the labour market. There have been no changes in the wage formation system that would allow greater differentiation according to productivity and skills. The remaining complexity of the tax system, despite the recent improvements, the high social security contributions and the stringent employment protection legislation are still important obstacles to hiring. Moreover, the limited impact of reforms aimed to promote flexible forms of employment point to the fact that many employers have ready recourse to flexibility through the informal economy. The reform of the public employment services, which is essential to address the high level of long-term unemployment, is still delayed.

Country specific recommendations to Greece

Meeting the challenges outlined above requires broad structural reforms as they are laid down in the general guidelines (GL) in part I of the broad economic policy guidelines.

In order to ensure the long-term sustainability of public finances in the face of population ageing, in particular in view of the high government debt ratio (GL 15), Greece is recommended to:

1. ensure that the government debt ratio is kept on a sustained declining trend at a satisfactory pace by maintaining high primary surpluses (GL 15);

2. ensure effective control of government current primary spending by addressing resolutely the problem of the inelastic elements of expenditures (GL 14), e.g. the wage bill;

3. use public resources more effectively with the aim of improving labour productivity and enhancing working capacity of the unemployed (GL 14); and

4. continue reforms of the social security system, and in particular the pension system (GL 16), in order to avoid budgetary strains in the future due to the problem of the ageing population.

In order to increase the low level of productivity, which is associated with problems in the functioning of the labour and product markets, low investment in human capital, and the late development of the knowledge-based society, Greece is recommended to (in line with GL 4 to 8 and 9 to 14):

5. step up efforts to increase the availability of skilled human capital, and continue to promote business involvement in R&D and innovation, and to improve ICT diffusion (GL 13 and E-REC 2);

6. enhance particularly competition in the energy sectors (GL 9);

7. continue to simplify the business and taxation environment and raise the transposition rate of internal market directives (GL 9 and 11).

Greece should also vigorously implement all the employment recommendations (E-REC), which deal with employment issues in greater detail. In order to increase growth potential, ensure the long-term sustainability of public finances, and address the effects of ageing populations, it is particularly important for Greece to reduce the high rate of structural unemployment, and increase employment rates, particularly for women. Greece is in particular recommended to:

8. improve work incentives, particularly by reducing non-wage costs and improving transferability of pensions rights, in order to encourage increased employment in the formal sector, including part-time work (GL 4 and 16 and E-REC 4);

9. promote changes to the wage bargaining process to ensure that wages reflect productivity differentials (GL 5); and

10. implement the labour reform package to improve the balance between flexibility and security by ensuring effective implementation of reforms aiming to modernise work organisation and by reviewing unduly restrictive labour market regulations (GL 6 and E-REC 1).

5. SPAIN

Spain's economic performance was remarkably strong in the second half of the 1990s with growth rates (close to 4 % on average) significantly exceeding those of the euro area, as well as its medium-term potential rate (estimated at around 3 %). Contrary to previous downturns, a positive growth differential has been maintained during the slowdown that began in 2001. This performance has been underpinned by unprecedented employment creation, while monetary conditions have also been particularly accommodating. On the downside, inflation has remained persistently higher than the average for the euro area. Measured productivity growth has declined, highlighting the need for continuing the structural reform process to enhance competition and flexibility.

To maintain its convergence towards higher-income economies within the EU (Spain's GDP per capita remains about 15 % lower than the EU average), the Spanish economy needs to consolidate the improved performance of the labour market, reduce unemployment disparities among regions and raise overall labour force participation. In turn, growth would be supported by increasing productivity through encouraging R&D and human capital formation and enhancing competition in some sectors. Achieving these objectives should underpin the fiscal consolidation registered in recent years. Nevertheless, the risk of future public finance imbalances as a result of the delayed but steep impact of ageing cannot be excluded. Therefore, to ensure the long-term sustainability of public finances and in addition to the initiatives already undertaken, the public pension system needs major reform, including in particular strengthening the link between contributions and benefits. The challenges facing Spain are to:

- raise the low employment rates, especially among women, and reduce wide regional labour market disparities,
- increase the low level of productivity, including by strengthening the knowledge-based economy in terms of educational attainment and skill levels, investment in IT, R&D and innovation performance,
- ensure the long-run sustainability of public finances in the face of population ageing.

Raise the low employment rates, especially among women, and reduce wide regional labour market disparities

Notwithstanding the great efforts and progress made with labour market reforms in recent years (unemployment rate reduced by more than 11 percentage points. since 1995), the unemployment rate at around 11,5 % remains significantly above the EU average, while the employment rate remains well below the EU average. The reduction in unemployment has been greater for women than for men, but the female unemployment rate is still more than double that of men. Moreover, despite high employment creation, unemployment is still unevenly distributed across regions. Wage setting takes little account in practice of substantial productivity differentials and indexation clauses in wage negotiations also create inefficient allocation of labour. The labour market remains heavily segmented between employees with permanent contracts and the large number on fixed-term contracts. In turn, the share of part-time jobs in employment remains low. Geographical labour mobility, while to some extent promoted by recent labour market and income tax reforms, is still limited, partly on account of structural obstacles, notably the poor functioning of the housing market. Additionally, the public employment services may lack the organisational resources to administer well-targeted active labour market measures and an unemployment benefit system based on job-seekers' individual commitment to activity.

Increase the low level of productivity, including by strengthening the knowledge-based economy in terms of educational attainment and skill levels, investment in IT, R&D and innovation performance.

Productivity in Spain is below the EU average and its growth has been very modest since the second half of the 1990s. This is in part a result of the strong increases in employment, which have been concentrated

in low productivity activities. Educational levels are relatively low. Low business investment in R&D is another barrier to faster productivity growth. The low patenting rate and insufficient investment in IT and e-commerce are indications of weak innovation. Productivity growth is also constrained by the insufficient competition in certain sectors, notably in retail trade and electricity.

Promising initiatives have recently been undertaken to increase competition in the electricity sector, however it is too early to assess their impact, and the four major vertically integrated incumbents still have monopoly in their respective regional markets, and import capacities still remain low.

Ensure the long-run sustainability of public finances in the face of population ageing

Although in Spain's case manifesting themselves later than in other countries, the long-term budgetary implications of ageing, above all for public pensions, but also for areas such as health expenditures, are of special concern. Most studies point to a very steep increase in the dependency ratio between 2020 and 2030, implying a growing budgetary impact. Strengthening long-term sustainability should therefore remain of primary concern in the framework of an ambitious three-pronged strategy. In this respect, recent measures aiming at reducing debt burden evolution, prolonging working life and raising participation rates, should be complemented with reforms of the public pension system. Key parameters such as the number of contributory years, the age of retirement and the replacement ratio remain unchanged and there is only a weak relationship between contributions and benefits.

Country specific recommendations to Spain

Meeting the challenges outlined above requires broad structural reforms as they are laid down in the general guidelines (GL) in part I of the broad economic policy guidelines.

Spain should also vigorously implement all the employment recommendations (E-REC), which deal with employment issues in greater detail. In order to raise growth capacity, ensure the long-term sustainability of public finances, address the effects of ageing populations and reduce regional disparities, it is especially important for Spain to raise the low employment rates, especially among women, and reduce wide regional labour market disparities. Spain is in particular recommended to:

1. continue to encourage increased labour market participation, especially among women, including through higher provision of childcare facilities and the promotion of greater use of part-time contracts (E-REC 2);

2. encourage a reform of wage setting in order to better reflect productivity taking into account productivity differences across skills, local labour market conditions and economic circumstances at the firm level, as well as phasing-out indexation provisions in collective agreements (GL 5);

3. further reform of employment protection legislation so as to reduce segmentation of the labour market across different types of contracts (GL 6 and E-REC 1); and

4. continue to facilitate the geographical mobility of workers by removing fiscal and other distortions, including by promoting the rental market for housing and removing rigidities in the availability of land for development (GL 7 and E-REC 3).

In order to increase the low level of productivity, including by strengthening the knowledge-based economy in terms of educational attainment and skill levels, investment in IT, R&D and innovation performance, Spain is recommended to (in line with GL 9-14):

5. step up efforts to increase skilled human capital, investments in R&D and innovation, and ICT diffusion (GL 13); and

6. continue to take measures to further enforce effective competition in certain sectors, such as retail distribution (GL 9), pursue ongoing efforts to reduce the administrative burden on business and monitor closely the developments on the electricity market (GL 11).

In order to ensure the long-run sustainability of public finances in the face of population ageing, Spain is recommended to:

7. complement recent initiatives by taking the appropriate steps to implement a major reform of the pension system, so as to strengthen the link between contributions and benefits and control the long-term increases in pension expenditure linked to the foreseen demographic changes (GL 16).

6. FRANCE

During the last five years, the French economy grew at a faster pace than its main European partners. This performance is to be largely attributed to strong job creation over a number of years, reflecting structural improvement in the labour market as well as accommodative budgetary policy after 1999. According to recent Commission calculations, potential real GDP growth still hovers slightly below 2,5 %, slightly above the average of the EU countries. The slow decrease of underlying inflation in the last six months suggests that the economy has been operating below its potential for several quarters.

In the coming years, potential output will start to be negatively impacted by the developments in the demographic structure. However, there is still much scope available for supporting potential growth through structural reforms both on the labour market, by means of increasing labour market participation and reducing structural unemployment, and on the product market, by improving effective competition in key network industries. Strengthening the efforts towards fiscal consolidation would create room for diminishing the tax burden weighing on labour cost and investment, thereby contributing to raise potential output. After the marked deterioration in the cyclically-adjusted budgetary position in 2002, which contributed to a deficit above the threshold limit of 3 % of GDP, consolidating government finances constitutes a major and urgent challenge for the French authorities. Pursuing budgetary consolidation further is also essential in view of the impact of the ageing population on public finances. The challenges facing France are to:

- reduce rapidly the general Government deficit to below 3 % of GDP and keep government finances on a steady consolidation path,
- increase labour market participation and reduce structural unemployment,
- ensure the long-term sustainability of public finances in the face of population ageing,
- ensure competition in the network industries and accelerate the adoption of internal-market measures, in order to create a level playing field.

Reduce rapidly the general government deficit to below 3 % of GDP and keep Government finances on a steady consolidation path

The general Government deficit reached 3,1 % of GDP in 2002 in France. The Commission therefore has adopted an opinion on the existence of an excessive deficit in France. On 3 June, the Council decided that an excessive deficit exists in France and adopted on a recommendation to France with a view to bringing an end to the excessive deficit situation. The Council recommends the French authorities to put an end to the present excessive deficit situation as rapidly as possible and by 2004 at the latest, in accordance with Article 3(4) of Council Regulation (EC) No 1467/97; it establishes a deadline of 3 October 2003 for the French Government to take appropriate measures to this end.

Subsequent to the approval of the budget, the Government took measures to control State expenditure in 2003 such as putting EUR 4 billion (0,25 % of GDP) in reserve, of which EUR 1,44 billion (0,1 % of GDP) were cancelled in March. Concerning health expenditure, the French government has already taken several steps to encourage control, for instance through a wider use of generic medicines. Nonetheless, these measures will not improve sufficiently the cyclically-adjusted budgetary position in that year as recommended by the Council. As a consequence, in the current context of subdued growth, the general Government deficit will very probably exceed the 3 % of GDP ceiling in 2003. France's debt-to-GDP ratio is also unlikely to reverse its rising trend to comply with the 60 % Treaty reference value in 2003. In view of these developments, and taking into account that the budgetary burden arising from an ageing population will start increasing rapidly from 2005 onwards, budgetary consolidation in France must be given strong priority.

Increase labour market participation and reduce structural unemployment

A key medium-term challenge for the French economy continues to be the structural problems in the labour market, as human resources, despite recent progress, are still under-utilised. France still has a relatively low overall employment rate (63,8 % in 2002) and a very low employment rate for older workers (among the lowest in the EU). In the context of an ageing population and after a reduction in statutory working hours, the challenge is to encourage labour force participation.

Further improvements in participation rates are to be achieved through further tax and benefit reforms, as well as from reforms to early retirement schemes and pensions systems. France also needs to continue to reduce the high rate of structural unemployment and, the mismatch between supply and demand, which is posing recruitment problems in certain sectors. Reductions in labour cost, especially for low-wage earners should be pursued. Labour market regulations should be further reviewed, especially by simplifying the enforcement of employment protection.

Ensure the long-term sustainability of public finances in the face of population ageing

Government finances challenges caused by the ageing population need to be urgently addressed. Under current conditions, avoiding the rapid increase in the deficit of the pension system, projected by the EPC to increase by 3,7 percentage points of GDP between 2000 and 2040, would require substantial increases in social security contributions. Such a development would increase considerably the burden on labour with a strong negative impact on the labour market. The Government has committed itself to implementing a reform of the pension system, before the end of the first half of 2003, after consultation with the social partners. Such reforms will help to ensure the sustainability of public finances in the long-term. These reforms will contribute to inter-generational fairness and an equitable treatment across different schemes. In the health sector, despite the recent adoption of structural measures designed to curb the dynamic of spending, expenditures are still projected to increase notably in 2003 and in the years beyond. The government has indicated its intention to decide on a reform of the health sector in the second semester of 2003.

The concern about long-term sustainability of public finances is all the more pressing as France's debt-to-GDP ratio is very likely to breach the 60 % threshold in 2003.

Improve the business environment, ensure competition in the network industries and accelerate the adoption of Internal-Market measures, in order to create a level playing field

Measures aimed at increasing the degree of market opening have been recently taken or announced, and while competition in segments of the electricity and gas markets remains weak, these markets now fulfil the legal openness requirements of EU directives. Market shares of the incumbents have decreased to around the average of European countries.

Business creation and growth are still hindered by the existence of different and complex social and fiscal procedures although new simplifying measures are being implemented. Although France has expressed its commitment to increase the rate of transposition of internal market directives, it continues to have the worst record amongst EU Member States in transposing and implementing these directives.

Country specific recommendations to France

Meeting the challenges outlined above requires broad structural reforms as they are laid down in the general guidelines (GL) in part I of the broad economic policy guidelines.

In order to reduce rapidly the general government deficit to below 3 % of GDP and keep government finances on a steady consolidation path, the French authorities are recommended to:

1. achieve a significantly larger improvement in the cyclically-adjusted deficit in 2003 than that currently planned;

2. implement measures ensuring that the cyclically-adjusted deficit is reduced in 2004 by 0,5 % of GDP, or by a larger amount, so as to ensure that the cumulative improvement in 2003-2004 is enough to bring the nominal deficit below 3 % in 2004 at the latest;

3. limit the increase in the general government gross debt to GDP ratio in 2003.

France should also vigorously implement all the employment recommendations (E-REC), which deal with employment issues in greater detail. In order to increase potential growth, ensure the long-term sustainability of public finances, and address the effects of ageing, it is especially important for France to increase labour market participation and reduce structural unemployment. France is in particular recommended to:

4. ensure that the new unemployment insurance system is fully implemented, including appropriate requirements and effective incentives to search for a job (GL 4 and E-REC 1).

In order to ensure the long-term sustainability of public finances in the face of population ageing, France is recommended to:

5. undertake with urgency a comprehensive reform of the pension system (GL 16), with the aim of ensuring its financial sustainability and increasing the effective retirement age, while adapting pension systems to more flexible employment and career patterns as well as to individual needs; and

6. monitor closely the efficiency of the measures undertaken to curb the dynamics of spending in the health sector so as to reduce it to a sustainable level, and, if necessary, introduce new measures to achieve this objective in the context of the reforms envisaged (GL 14).

In order to ensure effective competition in the network industries and accelerate the adoption of internal-market measures, in order to create a level playing field France is recommended to:

7. pursue efforts to ensure competition in energy markets, namely in gas and electricity sectors (GL 9);

8. sustain the efforts to reduce and simplify business regulations (GL 11); and

9. raise the transposition rate of internal market directives and bring down the number of infringement proceedings (GL 9).

7. IRELAND

Irish economic growth averaged a spectacular 10 % over the period 1995-2000. The concomitant impressive rise in employment ($5^1/_2$ % on average) was made possible by significant increases in labour force participation, a dramatic drop in unemployment and a reversal of the traditional net emigration pattern from 1996 onwards. As these sources of labour supply were exceptional, the economy increasingly suffered from supply constraints (both regarding labour and infrastructure) in the late nineties. As a result, and in line with the worldwide downturn, the pace of expansion slowed markedly from 2001 onwards. Looking forward, Ireland should benefit strongly from the expected global recovery on account of its high degree of openness. However, the era of double-digit growth has ended and Irish potential growth in the medium term is unlikely to exceed 5 %, around double that in the EU as a whole in view of a continuation, for the time being, of higher labour force growth and stronger productivity gains.

Creating stable macroeconomic conditions would facilitate the adjustment to this slower pace of expansion and help preserve the successes achieved during the past boom. Further, to ensure that economic potential is being exploited to the full, structural measures should be taken to strengthen the supply-side of the economy, which would also help to contain inflationary pressures. The challenge facing Ireland is to:

- achieve a smooth transition from double-digit economic growth in the late 1990s to lower, sustainable growth in the years ahead by ensuring stable macroeconomic conditions and by strengthening the supply-side of the economy.

Achieve a smooth transition from double-digit economic growth in the late 1990s to lower, sustainable growth in the years ahead by ensuring stable macroeconomic conditions and by strengthening the supply-side of the economy

Thanks to rapid growth in the previous decade, both the public finance position and the labour market situation improved considerably. The general Government balance was in surplus from 1997 to 2001, while the debt ratio is currently the second lowest in the EU. Looking forward, the implementation of the public investment programme and of social and health spending initiatives will have to reflect the moderation of economic and, thus, revenue growth and the need to improve value for money in public services delivery, (building on recent measures to improve expenditure management and control). Strong employment growth brought the unemployment rate down to below 4 % in 2001 (from above 15 % in 1993), but the increasingly tight labour market led to high rates of inflation and wage growth. Maintaining full employment, the aim of the recently negotiated social partnership agreement, requires prudent and flexible wage developments and measures to strengthen the supply side of the economy.

Reform in three broad areas appears most promising in order to boost the supply-side. First, the supply constraints experienced on the infrastructure front are being addressed in the framework of the National Development Plan 2000-2006. Output under the infrastructural programme in the Plan is behind target primarily because of rising construction and land acquisition costs. Second, in spite of the high proportion of ICT value-added in the economy, R&D spending is low in Ireland (at 1,2 % of GDP in 1999). Ireland's productivity would benefit from measures to raise R&D spending. Third, while some progress has been made, there remains an insufficient degree of competition in some sectors of the Irish economy, in particular the network industries and several other service sectors (such as professional services, retail distribution and insurance).

Country specific recommendations to Ireland

Meeting the challenges outlined above requires broad structural reforms as they are laid down in the general guidelines (GL) in part I of the broad economic policy guidelines.

Ireland should also vigorously implement all the employment recommendations (E-REC), which deal with employment issues in greater detail.

In order to achieve a smooth transition from double-digit economic growth in the late 1990s to lower, sustainable growth in the years ahead by ensuring stable macroeconomic conditions and by strengthening the supply-side of the economy, Ireland is recommended to:

1. enhance the efficiency of public expenditure and improve revenue and expenditure planning in a stability-oriented medium-term framework building on the range of measures recently introduced to improve the planning, management and control of expenditure. (GL 14);

2. encourage the social partners to adhere to a prudent and flexible wage norm to allow for adaptation to productivity and skill differentials and at the same time safeguard competitiveness (GL 3 and 5);

3. prioritise the roll-out of the infrastructural elements of the National Development Plan, while preserving budgetary stability, and pursue policy measures to raise the level of R&D (GL 13); and

4. increase competition in the network industries and in certain sectors of the economy, such as retail distribution (including the liquor trade), insurance and the professions (GL 9).

8. ITALY

Italy's economic growth has generally lagged behind that of the EU since the early 1990s. While the growth differential has narrowed during the last cyclical slowdown, *inter alia*, because of a less restrictive policy mix and of the first effects of labour market reforms, the rate of potential output growth is still estimated to be below the euro area average. Despite this relatively weak growth, consumer price inflation has typically been higher than elsewhere in the euro area, signalling structural weaknesses. Disappointing growth performance, together with a slackening of the fiscal adjustment effort since 2000, has hampered the structural consolidation of public finances. In light of Italy's very high debt ratio, the pace of debt reduction needs to be accelerated. Ongoing wage moderation and some important reform steps starting in 1998 have significantly improved the performance of the labour market, pushing the rate of unemployment below 9 % at the end of 2002. However, the rising contribution of labour to economic growth has been coupled with a marked slowdown in productivity partially due to the increased participation of low-skilled labour, especially in the service sector. In spite of significant improvements in the past years, participation rates are still among the lowest in the EU.

Taken as a whole, Italy's main problem remains low growth potential. Key factors holding back potential growth include the still unresolved condition of public finances, the persisting regional gap, especially in terms of the large share of inactive or unemployed working-age population in the South, as well as drags on total factor productivity such as the low levels of education and of R&D investment. The challenges facing Italy are to:

- rapidly consolidate public finances,
- ensure the long-term sustainability of public finances in the face of population ageing,
- raise the low employment rate, especially among women and older workers, and reduce the wide north-south economic disparities,
- strengthen the knowledge-based economy in terms of educational attainment and skill levels, investment in IT, R&D and innovation performance,
- continue to improve the business environment and to enhance competition in the energy and services sectors.

Rapidly consolidate public finances

In the run-up to the creation of EMU and immediately thereafter, Italy's fiscal accounts improved remarkably. However, in more recent years fiscal consolidation has slowed down, *inter alia*, due to markedly lower-than-expected growth and to a series of tax reductions. Reducing primary expenditures has proved problematic. In late 2002 and early 2003, the authorities adopted tighter controls and more transparent spending procedures, which should lead to improvements in future years. Ongoing decentralisation may require additional measures to enforce fiscal responsibility at all levels of government, while maintaining an adequate level of interregional transfers. The last few years have seen recourse to substantial sales of publicly-owned real assets and an array of tax amnesties. These transitory measures, while staving off the risk of breaching the 3 % of GDP deficit threshold, have replaced more fundamental action. The medium-term objective of cyclically-adjusted budget balance is, however, critical to placing public finances on a sustainable footing, given moreover that the debt ratio remains above 100 % of GDP and the fiscal implications of a severely ageing population are looming. Accelerating fiscal consolidation and reducing debt, and thus the present high debt servicing costs, will also create margins for improving the quality of expenditure.

Ensure the long-term sustainability of public finances in the face of population ageing

During the 1990s Italy took major steps to reform the pension system to avert unsustainable expenditure trends. However, given adverse demographic projections, ageing-related expenditure for healthcare and pensions is still projected to rise slightly in the next decade. Although designed to take into account the effects of changes in life expectancy and in the long-term growth rate of the economy, the new system might still be subject to significant financial imbalances in the event of adverse demographic and economic events. In this context, the high debt ratio creates tight constraints on fiscal policy, as sustained primary surpluses will need to be maintained over a long period. Some doubts remain on the ability of the announced changes in the social security system, while promoting privately-funded pension schemes, to address some existing critical issues in the public pension system, such as the long transition to a new contributions-based system or the effective start up of the so-called second pillar throughout the planned reduction of the contributions for newly hired workers.

Raise the low employment rate, especially among women and older workers, and reduce the wide north-south economic disparities

Despite improvements in recent years, there remains an important gap between the employment rates in Italy and the EU average, especially for women and older workers. National targets have been set in these areas. Overall, the large share of unutilised human resources chiefly reflects the persisting large regional gap, with the north recording high participation rates and almost full employment on one side and the south characterised by low participation and high unemployment on the other. This relative gap has been persistent, even though absolute performance has improved in both north and south. This may hide a large share of undeclared work. The regional pattern of employment and unemployment is very similar to the regional productivity differences, suggesting that the existing wage-bargaining system may be insufficiently flexible in taking into account such regional differences. In addition, lower productivity in the south is also likely to reflect the lower endowment of infrastructure. A further major weakness of the labour market is the imbalance between a limited system of unemployment benefits and relatively underdeveloped active labour market policies. This phenomenon, together with possible increase of flexible labour contracts, could increase the risk of a dual labour market structure. To mitigate the risk, the Legge Biagi of 2003 introduced measures to limit the danger of precarious jobs and social exclusion. This is pursued by increasing the flexibility at the margin, inter alia through the introduction of new labour contracts and the liberalisation of employment services, Finally, the implementation of long standing plans such as the lifelong learning strategy or the reform of the public service is lagging behind.

Strengthen the knowledge-based economy in terms of educational attainment and skill levels, investment in IT, R&D and innovation performance

Despite some progress the knowledge-based economy in Italy remains at an early stage. Educational levels remain relatively low, as is the availability of skilled human resources. Recently, some measures have been adopted to address these issues. Italy also ranks low in the area of Internet and e-commerce access and use. Business innovation is weak: business R&D expenditures relative to GDP (0,5 % in 2000) and patent applications relative to population reach barely half the EU average. The relatively large reliance of the Italian economy on small and medium size enterprises is a contributory factor, as these companies often lack the critical mass to carry out such activities.

Continue to improve the business environment and to enhance competition in the energy and services sectors

While measures have been taken to reduce red tape and to improve the business environment, administrative procedures for businesses remain rather costly and time consuming. This contributes to making the Italian business sector relatively less dynamic than that of other Member States, as measured by indicators on net business creation.

Effective liberalisation of the energy sector is proceeding. In the electricity market the incumbent's dominant position is declining, but third parties' access to the networks, while legally free, still remains difficult. This contributes to electricity and gas prices remaining among the highest in the EU. Competition in some service sectors is also being introduced relatively slowly, notably in the area of professional services and local public services. Finally, the rate of transposition of internal market directives deteriorated in 2002 and the number of infringements proceedings open before the European Court of Justice is the second worst in the EU.

Country specific recommendations to Italy

Meeting the challenges outlined above requires broad structural reforms as they are laid down in the general guidelines (GL) in part I of the broad economic policy guidelines.

In order to rapidly consolidate public finances, Italy is recommended to:

1. until a medium-term budget position close to balance or in surplus is achieved, ensure a reduction in the cyclically-adjusted deficit of at least 0,5 % of GDP per year (GL 1), replacing one-off measures by measures of a more permanent character;

2. strengthen policy coordination between all levels of government, by ensuring adequate and transparent enforcement mechanisms for fiscal discipline, while providing for clear sources of financing regional spending; and

3. finance further reductions in the tax burden through structural cuts in current primary expenditure within a comprehensive reform plan on both the expenditure and the revenue side.

In order to ensure the long-term sustainability of public finances in the face of population ageing, Italy is recommended to:

4. ensure that the debt ratio is diminishing at a satisfactory pace towards the 60 % of GDP threshold (GL 15); and

5. adopt further measures to address the critical issues in the public pension system (GL 16), in particular the long transition period to the new contributions-based system. The new system has been designed just to deal with adverse demographic shocks and promote supplementary privately funded pension schemes.

Italy should also vigorously implement all the Employment Recommendations (E-REC), which deal with employment issues in greater detail. In order to increase the growth capacity, ensure the long-term sustainability of public finances, address the effects of ageing populations and reduce regional disparities, it is especially important for Italy to raise the low employment rate, especially among women and older workers, and reduce the wide north-south economic disparities. Italy is in particular recommended to:

6. further encourage increased labour force participation, especially among women, including by adequate provision of child-care facilities; and among older workers, stepping up and reinforcing measures targeted at postponing retirement from the labour force (GL 4 and 16 and E-RECs 3 and 4);

7. further reform employment-protection legislation (GL 6), in order to facilitate job creation and adaptability and to reduce the segmentation of the labour market across type of contracts and firm size; and, at the same time, increase the resources and improve the efficiency of the unemployment benefit and social assistance system (GL 4 and E-RECs 1 and 6); and

8. encourage social partners to move towards more decentralised wage setting mechanisms that allow wages to better reflect different productivity conditions and individual skill levels (GL 5).

In order to strengthen the knowledge-based economy in terms of educational attainment and skill levels, investment in IT, R&D and innovation performance, Italy is recommended to:

9. pursue efforts undertaken to raise the overall education and skill base of the population, to further increase investment in R&D and innovation and to promote higher ICT take up, in particular through measures targeted at small and medium enterprises (GL 13).

In order to continue to improve the business environment and to enhance competition in the energy and service sectors, Italy is recommended to (in line with GL 9 to 14):

10. improve the business environment by reducing the administrative burden on businesses (GL 11); and

11. increase effective competition in the service sector, widen the opening of the energy markets, and improve the implementation of internal market directives (GL 9).

9. LUXEMBOURG

During the 1990s Luxembourg enjoyed very high rates of real GDP growth. However, in 2001 the open economy of Luxembourg experienced a very sharp slowdown, to a large extent due to the external environment. The economic downturn is also expected to lead to a worsening of public finances with a certain lag. The budget surplus of 6,1 % of GDP in 2001 is estimated to have decreased to 2,6 % of GDP in 2002 and deficits are forecast for 2003 and 2004. That said, the situation of Government finances in Luxembourg remains relatively favourable, in view of the low level of debt and the existence of budgetary reserves.

Faced with the prospect of a lower rate of economic growth than experienced for most of the 1990s, Luxembourg should attempt to raise its productive potential, while ensuring stability-oriented macroeconomic policies as the basis for sustainable growth. In order to promote growth and maintain sound public finances it is necessary to increase labour supply, both as a means to reduce expenditure and to increase tax revenues. To boost its productive potential, Luxembourg should primarily address two key challenges in the area of labour market and product market reform. The challenges facing Luxembourg are to:

- increase the low national participation and employment rates, especially for older workers,
- improve the business environment and encourage entrepreneurship in order to achieve a more balanced economic structure.

Increase the low national participation and employment rates, especially for older workers

Labour force participation in Luxembourg is below the EU average; the participation rates of older workers are particularly low. Employment growth has been possible thanks to cross-border workers and increased participation of national prime-age women, while virtually no progress has been achieved regarding the employment rate of older workers, despite some measures undertaken with the aim of increasing incentives to remain in the workforce. Mobilising part of the unutilised national employment potential is of great importance to enhance labour supply and thus provide an impetus to growth. Moreover, postponing withdrawal from the labour market would decrease benefit dependency, thereby reducing public expenditure on benefits and pensions. Incentives to remain in the labour force could be improved by further reforms of early retirement and pre-retirement schemes. Also the effects of the latest revisions in the disability pension scheme should be closely monitored.

Improve the business environment and encourage entrepreneurship in order to achieve a more balanced economic structure.

Regulation in the Luxembourg economy is still fairly high, notably for prices, and the reform aiming at modernising the competition framework has not yet been implemented. Whilst the high openness of Luxembourg brings competition from abroad, reforms to adapt domestic competition policy and their follow-up are necessary to maintain the benefits of competitive economic conditions.

Over the last decade, Luxembourg's economy has developed a high degree of specialisation in financial services. This situation has been so far beneficial to employment and growth but also makes Luxembourg more vulnerable to possible future sector-specific shocks. More accent on the development of small and medium sized enterprises, while strengthening key sectors such as financial services and diversifying the economy further, among others through facilitating foreign direct investment, should contribute to decrease this dependency and raise labour force participation and employment rates.

Country specific recommendations to Luxembourg

Meeting the challenges outlined above requires broad structural reforms as they are laid down in the general guidelines (GL) in part I of the broad economic policy guidelines.

Luxembourg should also vigorously implement all the employment recommendations (E-REC), which deal with employment issues in greater detail. In order to increase growth potential, it is especially important for Luxembourg to increase the low national participation and employment rates, especially for older workers. Luxembourg is in particular recommended to:

1. review incentives for early and pre-retirement and ensure appropriate eligibility rules in the disability pension scheme (GL 16 and E-REC 2).

In order to improve the business environment and encourage entrepreneurship to achieve a more balanced economic structure, Luxembourg is recommended to:

2. fully implement the reforms of competition law and to ensure that competition and regulatory authorities have sufficient independence, resources and power to fulfil their tasks (GL 9); and

3. take measures to encourage and facilitate the creation of SMEs and to help those to access venture capital (GL 11).

10. THE NETHERLANDS

From the mid-1990s to 2000, the Netherlands enjoyed rates of real GDP growth clearly exceeding the EU average, while the harmonised unemployment rate declined substantially to the second lowest level in the EU. From 2001 onwards, the economy experienced a marked economic slowdown, which also led to a significant worsening of public finances, and, with some delay, a deterioration in the labour market. Expectations are that an economic recovery would be relatively muted, while Government finances are projected to deteriorate further in the wake of the unfavourable macroeconomic situation. In 2003, real GDP growth is expected to remain below 1 %, after a growth rate of only 0,3 % in 2002. Potential economic growth is estimated to have slowed down to around 2 %, compared to $2^1/_4$ % in the rest of the EU. The weakened growth potential reflects a number of factors, including a high incidence of people relying on social security benefits, demographic trends, and a low level of competition in some sectors that hold back labour supply and productivity, and losses in external competitiveness, which may be partly attributed to sharp wage increases and insufficient business investment in R&D and innovation over the past years.

Faced with the prospect of a lower rate of economic growth than experienced for most of the 1990s, the Netherlands should attempt to raise its productive potential, while ensuring stability-oriented macroeconomic policies as the basis for sustainable growth. To this end, the Netherlands has to address three key challenges. The first key challenge addresses the sustainability of public finances while the next two relate to reforms of labour and product markets intended to mobilise under-utilised resources and increase competition and productivity as means to enhance economic growth. The challenges facing the Netherlands are to:

- pursue budgetary adjustment in the coming years in the face of weaker potential growth, and the budgetary costs of ageing,
- draw currently inactive people into the labour market,
- tackle the relatively slow productivity growth, stemming, inter alia, from the low level of competition in some sectors, and insufficient business investment, particularly in R&D.

Pursue budgetary adjustment in the coming years in the face of weaker potential growth and the budgetary costs of ageing

The situation of public finance in the Netherlands has deteriorated recently from a relatively favourable starting position, largely due to the sharp economic slowdown. In 2002, the nominal and cyclically-adjusted general Government deficit is estimated to have been around 1 % of GDP. However, at present it is difficult to assess fiscal policy in the coming years as no new Government has yet been formed following the Parliamentary elections of 22 January 2003. However, in the absence of policy changes, the Government balance is expected to deteriorate further in coming years. Thus, budgetary adjustment would be needed to achieve and maintain a budgetary position close to balance or in surplus. In particular, it is important that Government expenditure is brought in line with the revenue basis, reflecting the expected slowdown of the potential rate of real GDP growth.

Draw currently inactive people into the labour market

Despite a favourable labour market situation, inactivity in the Netherlands is still relatively high. Of particular concern is the high number of people currently on disability benefits, and the unemployment traps in the social benefit schemes, which continue to create disincentives for people to take up work. The substantial size of the untapped reserve of labour is illustrated by the number of benefit claimants, e.g. 7 % of the labour force receives unemployment and social benefits and 11 % receive disability benefits. Further improvement of employment rates will also depend on continued growth of female employment, and on a stronger activation of older persons and minorities. Mobilising the unutilised potential of labour supply is of primary importance in order to increase employment and provide a substantial stimulus for growth.

Tackle the relatively slow productivity growth, stemming, *inter alia*, from the low level of competition in some sectors, and insufficient business investment, particularly in R&D

Productivity growth has been relatively slow in the Netherlands since 1999, with levels falling further below the EU average in 2002. This may be partly attributed to rapid employment growth and labour hoarding. Low productivity growth can also be due, however, to the low level of competition in some sectors as well as the low and declining specialisation of the Netherlands in high and medium high tech manufacturing sectors. For example in construction, the Parliamentary Committee found evidence of illegal price agreements in 2002. In network industries, reform fatigue, partly stemming from perceptions that liberalisation has failed to benefit consumers, has slowed down progress in tackling the still insufficient degree of competition. The weakness of the regulatory regimes in liberalised sectors explains in part why the benefits of reform have not yet materialised fully. Low investment in R&D acts as a drag on productivity growth in the Netherlands. In the second half of the 1990s, business investment in R&D was 10 % below EU average and even more below that of neighbouring countries such as Belgium and Germany. A particular problem is the low level of science and technology graduates aged 20 to 29, who provide the principal source of the future stock of researchers.

Country specific recommendations to the Netherlands

Meeting the challenges outlined above requires broad structural reforms as they are laid down in the general guidelines (GL) in part I of the broad economic policy guidelines.

In order to pursue budgetary adjustment in the coming years in the face of weaker potential growth, and the budgetary costs of ageing, the Netherlands is recommended to:

1. continue to contain government expenditure within clearly defined ceilings set in real terms, consistent with a budgetary position close to balance or in surplus (GL 1 and 14).

The Netherlands should also vigorously implement all the employment recommendations (E-REC), which deal with employment issues in greater detail. In order to increase growth potential, ensure the long-term sustainability of public finances, address the effects of ageing populations and promote inclusion in the labour market, it is especially important for the Netherlands to draw currently inactive people into the labour market. The Netherlands is in particular recommended to:

2. push forward with reforms of benefit systems in order to make work pay (GL 4 and E-REC 3). Concentrate, in particular, on benefit eligibility and conditionality. Legislate and implement the planned reform of the disability scheme, thereby paying attention to both the inflow and to the activation of those who already receive benefits.

In order to tackle the relatively slow productivity growth, stemming, *inter alia*, from the low level of competition in some sectors, and insufficient business investment, particularly in R&D, the Netherlands is recommended to (in line with GL 9 to 14):

3. improve the regulatory framework as well as its implementation (GL 11), especially in sectors where competition has been found to be inadequate, such as construction and professional services; and

4. promote a more technology oriented education and strengthen science-industry links with the aim of increasing business investment in R&D (GL 13).

11. AUSTRIA

Since the 1970s, real GDP growth in Austria has on average been slightly higher than in the EU. Potential output growth, however, is estimated to have been declining since 1990 from above to below the EU-average. While in 1990 potential output growth in Austria was estimated at 3,1 % (compared with an EU average of 2,8 %), it fell to 1,9 % in 2002 (2,2 % on average in the EU) and is projected to drop further. Population-ageing and barely rising labour force participation rates, combined with below average total factor productivity growth, play a major role in these subdued prospects. The same factors also weigh on public finances, with a twofold impact: first, low potential growth is tantamount to foregoing revenues and second, population ageing exerts upward pressure on spending. As expenditure cuts did not break underlying spending pressures, the tax burden remained high in particular since 1995 and peaked in 2001, implying the danger of setting in motion the vicious circle of a high tax burden and slow growth. In order to ease the constraints on public finances and resume above-average gains in incomes and living standards, Austria should seek to strengthen incentives to hire, work and invest. This in turn requires achieving and maintaining a budgetary balance at lower ratios of taxes and expenditure to GDP.

A main factor holding back Austria's growth potential are the negative consequences on labour supply induced by high social transfers and ample provisions of public services, which, combined with the budgetary effects of population ageing, resulted in a persistent upward pressure on public expenditure. This, in turn, gives rise to a high tax burden, in particular on labour, while at the same time discouraging labour force participation as well as on labour demand. In addition, a feeble innovative capacity, in particular poor diffusion of technology, thus resulting in a weak technology base, remains one of the fundamental problems of the Austrian economy. Therefore, public spending could usefully be redirected towards these growth-enhancing items in an efficient way. Moreover, an insufficient degree of competition in some product markets appears to be an additional obstacle to more dynamic growth. The challenges for Austria are to:

- ensure the sustainability of public finances in the face of population ageing,
- continue to improve the weak technology base, and encourage business R&D and innovation,
- strengthen the development of effective competition in some sectors.

Ensure the sustainability of public finances in the face of population ageing

Austria's pension system is financed nearly exclusively on a pay-as-you-go basis, although recent measures aim at strengthening privately funded systems. Despite a reform in 2000 and fairly moderate benefit increases in recent years, the long-term sustainability of the pension system is at risk in view of the projected population ageing. The adverse demographic dynamics is exacerbated by the — at 58 years — low actual average effective retirement age and the very low employment rates for older workers, despite the fact that the overall employment rate already exceeds the EU target for 2005. Moreover, as pension benefits are currently calculated on basis of only 15 — in the future 18 — working years with the highest earnings, there is a weak link between contributions and benefits, and the current level on pension spending as a share of GDP is one of the highest in the EU. If the present system were to remain unchanged or to be modified only marginally, the already high tax burden would need to increase further, with negative consequences for labour supply and demand and, thus, for growth potential. In December 2002, an expert group, the Pension Reform Commission, presented a comprehensive report, which elaborated on various options for reform. Also the health care system, despite recent measures to contain spending, will come under increasing financial strain.

The concern about long-term sustainability of public finances is all the more pressing as Austria's debt-to-GDP ratio remains above the 60 % threshold, and where a clear downward trend has not yet been established.

Continue to improve the weak technology base, and encourage business R&D and innovation

Weak effective competition in some sectors has put too little pressure on the business sector to innovate and to invest in research and development. The level of R&D expenditures as a percentage of GDP has slowly been increasing to the EU average, but the share of business R&D progressively has declined from around 50 % to about 40 % since 1992. In addition, IT expenditures remain below the EU average and the level of venture capital investment is amongst the lowest in the EU. Besides a low degree of competition, the relatively heavy reliance of the Austrian economy on small and medium sized enterprises contributes to explaining these low levels of R&D and innovation, as these companies often lack the critical mass to carry out such activities.

To improve this weak technology base, Austria is developing programs to offer financial and fiscal incentives to innovate and to coordinate SMEs efforts. The growing number of patents and the good level of tertiary graduates in science and technology are positive developments that could be used as levelling tools.

Strengthen the development of effective competition in some sectors

Until the late 1990's, the relatively low degree of openness of the Austrian economy, the long tradition of relying on social consensus and regulations, and the need to involve social partners and Länder to achieve reforms act as constraints on the competition framework. The economy faces high concentration in certain sectors such as print media, food retailing, drugstores, insurance, furniture retailing, or network industries. The reform of the Austrian law on competition and the establishment of an independent federal competition authority are recent developments that could create a more competitive environment. However, the new competition authority needs to establish itself and has started its investigations as of 1 July 2002, and needs to build a credible record. This situation is made difficult by understaffing. In addition, sector regulators, such as in the telecommunications sector, sometimes lack the power to effectively enforce their decisions, leading to long proceedings in Courts before a decision is made effective.

Country specific recommendations to Austria

Meeting the challenges outlined above requires broad structural reforms as they are laid down in the general policy recommendations (GL) in part I of the Broad Economic Policy Guidelines.

Austria should also vigorously implement all the Employment Recommendations (E-REC), which deal with employment issues in greater detail.

In order to ensure the sustainability of public finances in the face of population ageing, Austria is recommended to:

1. implement measures leading to structural expenditure savings, also at lower levels of government, so as to lower the high tax burden, while securing a cyclically-adjusted budgetary position close to balance (GL 1); and

2. reform the public pension system to ensure the sustainability of public finances (GL 16); in particular link more closely the level of pension benefits to life-long contributions; increase the low average effective retirement age and ensure in this context that incentives to work are enhanced (GL 4 and E-RECs 2 and 3), with a view to raising the labour market participation of older workers.

In order to continue to improve the technology base and encourage business R&D and innovation, Austria is recommended to:

3. take measures to encourage business research and innovation, especially for SMEs, (GL 13).

In order to strengthen the development of effective competition in some sectors, Austria is recommended to (in line with GL 9 to 14):

4. increase the resources of the competition authority and to take measures to enhance effective enforcement of regulators' decisions in telecommunications (GL 9).

12. PORTUGAL

In the 1995-2000 period, economic growth averaged 4 %, driven by strong domestic demand. Since 2001, economic activity has been decelerating under the influence of cyclical weakness in Europe. This development has been accentuated by the ongoing correction of the macroeconomic imbalances that emerged in the second half of the 1990s, notably a significant external deficit, and unsatisfactory progress in fiscal consolidation, leading to a major budgetary slippage in 2001. The measures taken in 2002, notably the adoption of a rectifying budget, represent a first step towards narrowing the abovementioned imbalance. In 2003, weak international developments and further adjustment in households' demand should contribute to economic growth remaining below 1 % for a second consecutive year, well below potential growth which is estimated at around $2\,^3/_4$ %-3 % (about $^1/_2$ percentage point above the EU average). This positive growth differential is somewhat misleading, because it largely reflects a strong rise in the growth of factor inputs, accompanied by only small gains in total factor productivity. Low productivity growth in Portugal is mainly a structural problem, associated with the low efficiency of the education system, insufficient competition, low spending on R&D, and weak ICT diffusion. In combination with relatively high nominal wage growth, Portugal's competitiveness has therefore gradually been eroded.

The budgetary consolidation strategy defined in the latest update of the stability programme rests to a large extent on the successful implementation of comprehensive structural reforms. Given the intention to lower over the medium-term the total revenue-to-GDP ratio, reflecting the planned reduction in corporate taxes in order to strengthen the international competitiveness of the Portuguese economy, this leaves only one road open to ensure budgetary consolidation on a sustainable basis. This is the restraint of current primary expenditure growth, which in turn requires the implementation of structural reforms. Another major aim of the envisaged reforms is to enhance the growth potential of the economy, through policies to secure a sustained improvement in total factor productivity. The challenges facing Portugal are to:

- accelerate the consolidation of public finances and address the strong dynamics of Government expenditure,
- increase overall competitiveness which is at risk from the low efficiency of the education system, low R&D spending, a low degree of competition in certain sectors, and high nominal wage growth,
- ensure the long-term sustainability of public finances in the face of population ageing.

Accelerate the consolidation of public finances and address the strong dynamics of government expenditure

In the period that led to the budgetary slippage of 2001, the rate of growth of current primary expenditure was consistently above that of nominal GDP [1]. For most of the second half of the 1990s, this was compatible with the pursuit of budgetary consolidation as buoyant domestic demand boosted tax revenues. However, this pattern of budgetary consolidation came to an end with the deterioration in cyclical conditions in 2001, and the disappearance of the dampening effect on interest expenditures caused by the convergence of interest rates to the lower levels prevailing abroad. Budgetary consolidation resumed in 2002, although due to the usual lags associated with the implementation of structural adjustments, it had to rely greatly on the adoption of one-off measures. In the short-term, the adoption of non-recurrent measures is necessary to regain the lost momentum in budgetary consolidation and to reinforce policy credibility, thereby buying time for the government's expenditure-releasing structural measures to take hold.

[1] In the 1995-2001 period, current primary expenditure increased by 9 % per year, while nominal GDP grew by 7,2 % per year; consequently, the current primary expenditure-to-GDP ratio rose from 33,4 % in 1995 to 36,7 % in 2001.

In order to accelerate the consolidation of public finances and address the strong dynamics of government expenditure, a determined and timely implementation of the structural reform measures announced in the January 2003 update of the stability programme is required. Reforms in key areas, notably in public administration, education, healthcare, and social security, are likely to have a direct impact on budgetary consolidation. Other reforms (for instance in the labour market) are likely to have an indirect impact on budgetary consolidation, either by fostering a more efficient use of resources, or by broadening the tax bases as a result of successful supply-side policies.

Increase overall competitiveness, which is at risk from the low efficiency of the education system, low R&D spending, a low degree of competition in certain sectors, and high nominal wage growth

The weak productivity performance and high nominal wage growth have both contributed to the deterioration observed in Portugal's external competitiveness. First, labour productivity in Portugal is the lowest in the EU and is growing slowly. The main reason for this is the low average level of education attainment also for the younger age groups. The insufficient levels of investment in R&D and innovation by the business sector and the weak ICT diffusion also deprive Portugal of an important source of productivity gains. The low leverage effect of R&D public financing over private investment in R&D and innovation is a sign of inefficiencies in the national research and innovation system. Insufficient competition in network industries is another key restraint. Second, nominal wage growth has increased by around 6 % a year during the last 10 years (double that of the EU 15), even if a certain wage moderation has been noticed in recent years.

Although Portugal has increased spending on education substantially in recent years, the share of early school-leavers without upper-secondary education and not in training is by far the highest in the EU ([1]). A breakdown of education expenditure by main categories shows that a relatively high fraction goes into the wage bill compared with other developed countries, suggesting an inefficient use of resources. Despite recent progress, the level of vocational training is significantly below the EU average. It has proved difficult to involve small enterprises in the national programmes designed to upgrade the skills of their staff.

Ensure the long-term sustainability of public finances in the face of population ageing

The challenges posed to the long-term sustainability of public finances reinforce the need of securing a fast pace of debt reduction prior to the budgetary impact of population ageing taking hold. For this, it is crucial to successfully complete the process of budgetary consolidation, reaching a budget position of close-to-balance or in surplus by 2006 as envisaged in the January 2003 update of the stability programme of Portugal and sustaining it thereafter. This is a necessary, but not sufficient, step to ensure the sustainability of public finances. It must be supplemented by the determined implementation of a number of structural reforms in order to curb the growth of age-related expenditures, and to raise to the overall growth potential of the economy.

Country specific recommendations to Portugal

Meeting the challenges outlined above requires broad structural reforms as they are laid down in the general guidelines (GL) in part I of the broad economic policy guidelines.

Portugal should also vigorously implement all the employment recommendations (E-REC), which deal with employment issues in greater detail.

([1]) 45,5 % in 2002 for both genders, and 52,9 % for males.

In order to accelerate the consolidation of public finances and address the strong dynamics of government expenditure, Portugal is recommended to:

1. ensure that the Government deficit is further reduced in 2003 as planned, and that the cyclically-adjusted deficit is thereafter lowered by at least 0,5 % of GDP a year in order to reach a budget position that is close to balance (GL 1);

2. ensure that the deficit reduction is obtained mainly through the expenditure side by firmly executing budgetary plans for all sub-sectors of the general government (GL 14); and

3. undertake structural reforms in areas with a more direct impact on budgetary consolidation, notably in public administration, education, healthcare, and social security.

In order to increase overall competitiveness, which is at risk from the low efficiency of the education system, low R&D spending, a low degree of competition in certain sectors, and high nominal wage growth, Portugal is recommended to (in line with GL 9-14):

4. promote the stronger involvement of the business sector in R&D spending and innovation (GL 13), together with higher ICT take-up;

5. improve the efficiency of spending in education with a view to, *inter alia*, raising the qualification of human resources (GL 13 and E-REC 1), and reducing substantially the number of early school-leavers with insufficient levels of schooling or training;

6. enhance effective competition in liberalised utilities, especially in the energy sector, and create a better competitive environment by increasing the transposition rate of internal market directives (GL 9); and

7. encourage the social partners to secure wage moderation, while allowing wage increases to take into account productivity and skill differentials, with a view to improving competitiveness (GL 3 and 5).

In order to ensure the long-term sustainability of public finances in the face of population ageing, Portugal is recommended to:

8. increase the efficiency of the healthcare system by introducing a wide range of measures that strengthen market mechanisms and rationalise demand (GL 14); and

9. adopt further reforms to the pension system for workers in the general government sector to secure its long-term sustainability and in order to progressively align it with the pension regime for private sector workers (GL 16).

13. FINLAND

Sustained efforts during the 1990s towards producing and using information and communication technology has transformed Finland into one of the leading — if not the most — knowledge-based economies in the world. This contributed, alongside market liberalisation, to real GDP expanding during the second half of the 1990s at an annual rate of nearly 5 %, i.e. well above potential (of around 3 %). The slump in external demand, and particularly in the telecom sector, since 2000 caused output growth to fall below its potential. With domestic demand holding up, activity could move close to potential by 2004, in line with improving external conditions.

The current overall unemployment rate of just above 9 % of the labour force in 2001-02 appears to be mainly structural. The employment rate for older workers has risen rapidly since the 1994 trough, but is still over 20 percentage points lower than that for all employees. These two factors together with fairly lengthy periods spent in education and the ageing population are becoming obstacles to reaching the Government's target of raising the employment by 100 000 jobs during the election period and the employment rate to 75 % until 2010. The price level in Finland exceeds that of the EU average by almost one-fifth, in spite of recent moderation in headline inflation, suggesting deficiencies in competition, in particular in sheltered service sectors. Furthermore, the financing of welfare services requires a fairly high level of taxation, which may be difficult to maintain in view of erosion in tax bases, and enhanced tax competition. The need for keeping a heavy tax burden could be eased by the absence of expenditure overruns observed in central government spending. The challenges facing Finland are to:

- reduce the high level of structural unemployment and increase the employment rate of older workers,
- enhance competition in certain sectors and improve the efficiency of the public sector.

Reduce the high level of structural unemployment and increase the employment rate of older workers

Finland exceeds the overall and female employment targets for 2005 for the EU as a whole, as well as the Lisbon target for the female employment rate for 2010, but the goal of an employment rate of close to 70 % is not yet reached. This will become very difficult to achieve, due to demographic constraints. Thus, an increase in the employment rate and in the labour supply will require that older workers remain longer in the labour market. The overall unemployment rate fell by $7^1/_2$ percentage points from its peak of 1994 to 9,1 % in 2002 (but was unchanged from 2001 reflecting sluggish economic activity). Most estimates indicate a NAIRU of about 8-9 %, thus suggesting that the registered unemployment rate is mainly structural. Several measures have recently been introduced both to improve the employability of the unemployed and to boost labour supply among older workers. Measures have been initiated, *inter alia*, to reduce the high tax burden on labour, to target active labour market programmes, to tighten the eligibility rules for early retirement, and to abolish the 60 % ceiling for the accrual of the pension rights. These steps are welcome, but not sufficient, and some of the steps taken work in the opposite direction, notably more generous unemployment benefits and allowing access to the unemployment pension scheme to continue up to 2008. Moreover, the phasing-in period for certain measures of the pension reform appears somewhat protracted, delaying the positive impact of the reforms on containing the pension expenditure.

Enhance competition in certain sectors and improve the efficiency of the public sector

Enhancing competition could help to lower the Finnish price level, which is one of the highest in the EU, and to improve productivity, which is around the EU average. This high price level can only be partly explained by high indirect taxes, the remoteness of the country and low population density. Investigations by the national competition authority point to lack of competition in some sectors, e.g. in network

industries. The relatively feeble overall level of labour productivity for a country advanced in the transition towards a knowledge-based economy could also be due to the large public sector and the limited competition for the provision of public services. Government reports show that there are potential efficiency gains in the public sector, which could have large positive effect on the sustainability of public finances.

Strong economic activity during the second half of the 1990s generated sizeable revenues, in particular from corporate and capital income, although they have recently returned to normal. While this provided some leeway for additional public spending, slippage over Government spending targets on the one hand, and over-reliance on the exceptionally high tax intake on the other hand, are becoming a risk to the current healthy financial position of central and local government finances. A more efficient use of current resources and containment of government spending would provide some leeway for responding to pressures for maintaining the level of financing of the current services.

Country specific recommendations to Finland

Meeting the challenges outlined above requires broad structural reforms as they are laid down in the general guidelines (GL) in part I of the broad economic policy guidelines.

Finland should also vigorously implement all the employment recommendations (E-REC), which deal with employment issues in greater detail. In order to increase growth potential, it is especially important for Finland to reduce the high level of structural unemployment and increase the employment rate of older workers, Finland is in particular recommended to:

1. improve incentives in tax and benefit systems further to make work pay, in particular by addressing their combined effects on older workers, continue to reform the eligibility criteria, improve the administration of benefit systems and target the tax measures on low-paid labour (GL 4 and E-REC 2); and

2. seek possibilities to ensure that wage bargaining systems allow wages to better reflect productivity differences across skills in order to improve the job prospects of low-skilled unemployed (GL 5).

In order to enhance competition in certain sectors and improve the efficiency of the public sector, Finland is recommended to (in line with GL 9-14):

3. step up efforts to enforce competition in network industries and non-tradable services (GL 9);

4. make further efforts to increase the efficiency of the public sector, inter alia by improving the framework conditions for increased competition, promoting the benchmarking of public sector efficiency and by increasing public tendering (GL 11); and

5. improve mechanisms to help control spending and ensuring compliance with rules on expenditure (GL 14).

14. SWEDEN

Sweden has experienced relatively high economic growth in recent years and has shown some resilience to the weak level of global activity. In particular, unemployment has remained low and public finances sound. The sound fiscal position has permitted Sweden to ease its fiscal stance in order to counter the downturn. The overall Swedish fiscal strategy of sustaining high surpluses in the longer term, underpinned by a budgetary framework of ensuring tight expenditure control, is expected to result in the continuation of a fiscal position 'close to balance or in surplus' in the coming years. Inflationary pressures are expected to continue to be in line with the inflation target range of 2 % ± 1 percentage point guiding monetary policy, underpinned by the gradual closing of the output gap.

The Swedish Welfare State is the most comprehensive in the Union, with both the overall tax burden [1] and public expenditure exceeding 50 % of GDP. This reflects social priorities, which generally enjoy widespread support. In order to safeguard the achievement of placing the public finances on a sustainable path, it is important to ensure an efficient use of public resources, not least as an ageing population will put a further upward pressure on expenditures. Furthermore, measures to enhance competition are necessary to address the high price levels and low labour productivity. In addition, and while Sweden ranks high in terms of employment rates, increasing labour force participation and fostering employment still remains a key challenge in order to sustain the financing of the welfare state in the longer term. The challenges facing Sweden are to:

- ensure an adequate labour supply in view of the ageing of the population,
- enhance competition in certain sectors and improve the efficiency of the public sector.

Ensure an adequate labour supply in view of the ageing of the population

Employment rates are already very high in Sweden, and well beyond the Lisbon targets for EU as a whole, including for women and older workers, and the Government has set a target to increase the employment ratio further. In view of the ageing population, there will be a need to increase labour supply, in particular by exploiting potential sources of labour among immigrants, the young and the long-term sick. Additional efforts appear necessary to improve further the incentives to work, notably as Sweden still has the highest overall tax burden in the EU and relatively generous benefit schemes in an international perspective. The comprehensive Swedish Welfare State involves a long-term challenge for the Swedish economy. Its financing implies a continued high overall tax burden and therefore also a substantial tax wedge with adverse effects on the incentive structure. To this end, reducing the most distortionary elements of the tax and benefit systems would be beneficial for growth and employment. Reducing the number of persons receiving various benefits is also important with regard to public finances. The problematic situation with extensive recourse to sick-leave and early retirement deserves particular attention, not least as the associated budgetary costs are high. The Government has set targets to halve the number of persons receiving social assistance by 2004 and to halve the number of days of sick leave by 2008.

Enhance competition in certain sectors and improve the efficiency of the public sector

Enhancing competition could contribute to lower the Swedish price level, which is one of the highest in the EU, and to improve productivity, which is below the EU average. The high price level can only be partly explained by high indirect taxes, the remoteness of the country and low population density.

[1] Payments from public insurance schemes are taxed in Sweden. This 'institutional aspect' in Sweden results in a higher tax burden as measured by the Commission services.

Competitive shortcomings are found in the private sector, as evidenced by the fact that the Swedish price level remains more than 20 % above the EU average. A study from the Swedish competition authority concludes that around half of this difference is explained by insufficient competition. In particular, price levels are markedly higher in retailing, housing, construction and non-tradable services.

Sweden has one of the largest public sectors in the EU, which could be one reason for the low labour productivity. Public operators are starting to concede market shares in the area of public services provision, but private operators still only represent a small share of employment in welfare services. Increased efficiency in the provision of public services is important in order to ensure that the population gets value for money.

Country specific recommendations to Sweden

Meeting the challenges outlined above requires broad structural reforms as they are laid down in the general guidelines (GL) in part I of the broad economic policy guidelines.

Sweden should also vigorously implement all the employment recommendations (E-REC), which deal with employment issues in greater detail. In order to increase growth potential and ensure the long-term sustainability of public finances, it is especially important for Sweden to ensure an adequate labour supply in view of the ageing of the population, Sweden is in particular recommended to:

1. pursue further the reforms of tax and benefit systems to improve work incentives, in particular for those groups with high marginal effective taxes (GL 4 and E-REC 3), and complete the tax reform on labour income while maintaining sound public finances.

In order to enhance competition in certain sectors and improve the efficiency of the public sector, Sweden is recommended to (in line with GL 9-14):

2. step up efforts to enforce competition in sectors where competition is inadequate (GL 9); and

3. make further efforts to increase the efficiency of the public sector, inter alia by improving framework conditions for increased competition, promoting the benchmarking of public sector efficiency, and by increasing public tendering (GL 11).

15. UNITED KINGDOM

The United Kingdom economy has enjoyed almost a decade of sustained output growth. Inflation is among the lowest in the EU and unemployment is at a 27-year low. The underlying outlook is broadly positive, but there are downside risks. Among these is the possibility of an abrupt slowdown in the growth of household consumption from recent high levels, as households begin to adjust to lower gross wealth as a result of the recent equity market slump. So far, the sector has been cushioned by continued rises in housing wealth, although the most recent indicators point to a slowdown in house price inflation. The public finances moved into deficit of 1,3 % of GDP in 2002 and a deficit is expected to persist in both 2003 and 2004 — partly for cyclical reasons associated with low financial company profits and planned rises in current and capital expenditure relative to GDP, the latter aimed at rectifying historical under-investment in public infrastructure. The United Kingdom has made further progress on the labour market in recent years, with further reforms of tax and benefit systems and the development of a range of targeted active measures. Labour market performance remains among the best in the EU with unemployment at around 5 %. In particular, despite the relatively tight labour market, wage pressures are subdued and are expected to remain that way. All in all, HICP inflation is projected to average under 2 % in 2003 and 2004.

The relatively low level of productivity, resulting inter alia from low basic skills among some categories of worker, remains a key challenge. Labour productivity is below the EU average although the gap has been declining since 1995. At the same time, expenditures on R&D as a percentage of GDP are just below the EU average. A second key challenge is to address the high numbers of working-age people claiming sickness and disability benefits, which may be an obstacle to a further increase in labour supply. The third key challenge is to improve the quality and efficiency of United Kingdom public services. The challenges facing the United Kingdom are to:

- improve the relatively low level of productivity,
- address the high numbers of working-age people claiming sickness and disability benefits and sustain labour supply in the longer term,
- improve the quality and efficiency of public services.

Improve the relatively low level of productivity

The United Kingdom's level of productivity is historically weak compared to the EU average. Although the productivity gap with the EU has been declining in recent years, United Kingdom labour productivity was still below the EU average in 2002. The United Kingdom's productivity growth may have been slowed by low-skilled people entering employment in recent years. However, other structural factors are important for raising the United Kingdom's productivity performance such as competition, entrepreneurship, science and innovation, skills and investment. The United Kingdom Government has taken many measures in recent years to increase productivity, but it will take time for the full effects of these measures to feed through into the productivity statistics, and further measures may be needed. The recently strengthened competition policy will need to be applied rigorously, in particular, to the professions and pharmacies, where the Office of Fair Trading has found that regulations inhibit the level of competition, and postal services, where the incumbent has had a monopoly until recently. Measures to promote R&D and skills should also contribute to higher productivity.

Address the high numbers of working-age people claiming sickness and disability benefits and sustain labour supply in the longer term

The United Kingdom exceeds all of the employment targets set by the European Council, with an overall employment rate of 71,6 % in 2002 and rates of 65,3 % and 53,5 % for women and older workers.

Unemployment was 5,2 % in 2002. The United Kingdom has made further progress on the labour market in recent years, with further reforms of tax and benefit systems and the development of a range of targeted active measures. However, high employment rates are accompanied by relatively low levels of productivity, in part due to both insufficient levels of basic skills and a lack of access to training among some categories of worker. The number of working-age people claiming sickness and disability benefits remains high at just over 3 million, of which 2,7 million claim income-replacement benefits, which may limit the scope for further increases in labour supply. The United Kingdom recognises the importance of addressing levels of inactivity among the long-term sick and disabled.

In addition to existing measures, such as the New Deal for Disabled People, the Government is considering the scope for further action and has announced plans to trial earlier and more intensive support for recipients of incapacity-related benefits. Although overall unemployment remains well below the EU average, there are significant disparities in terms of access to the labour market with concentrations of inactivity and unemployment in certain localities and among particular groups of the population. The United Kingdom's comprehensive Welfare to Work strategy aims to tackle long-term unemployment and provides targeted help to those groups experiencing the greatest employment disadvantage.

Improve the quality and efficiency of public services

Rising demand and higher expectations of service quality have put pressure on the delivery of public services. In addition, public services have suffered from under-investment in the past. These developments have manifested themselves in problems such as waiting lists, deteriorating infrastructure and staff shortages in some areas. Therefore, the United Kingdom Government has budgeted for a large increase in expenditure on public services. Under-investment in the public infrastructure is being addressed, with public sector net investment expected to more than double in real terms from 2000-2001 to around 1,4 % of GDP by 2002-2003, rising further to 2,0 % of GDP by 2005-2006. Moreover, education spending is planned to grow by 5,9 % per year in real terms until 2005-2006 and healthcare spending is planned to grow by 7,4 % per year in real terms over the same period. The United Kingdom Government has recognised the need to accompany the increases in expenditure with reforms designed to ensure that these resources are used and allocated efficiently and effectively, that consumers receive higher quality public services and that both consumers and taxpayers receive best value for money.

Country specific recommendations to United Kingdom

Meeting the challenges outlined above requires broad structural reforms as they are laid down in the general guidelines (GL) in part I of the broad economic policy guidelines.

In order to improve the relatively low level of productivity, the United Kingdom is recommended to (in line with GL 9 to 14):

1. continue to improve competition in sectors like the professions, postal services and pharmacies (GL 9);

2. monitor closely existing measures to promote R&D (GL 13); and

3. review and strengthen, where appropriate, policies aimed at improving basic skills in the work force (GL 13).

The United Kingdom should also vigorously implement all the employment recommendations (and E-REC), which deal with employment issues in greater detail. In order to increase growth potential and to promote labour market inclusion, it is especially important for the United Kingdom to address the high numbers of working-age people claiming sickness and disability benefits and sustain labour supply in the longer term. The United Kingdom is in particular recommended to:

4. ensure that all those who are able to work have the opportunities and incentives to do so, in particular by examining and reforming as necessary sickness and disability benefit schemes (GL 4 and E-REC 3).

In order to improve the quality and efficiency of public services, the United Kingdom is recommended to:

5. ensure that the public services associated with the announced increases in public expenditure (including investment in the transport infrastructure) are delivered efficiently and with a view to ensuring cost-effectiveness (GL 11 and 14).

Done at Luxembourg, 26 June 2003.

For the Council

The President

G. DRYS