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Commission's Recommendation for the Broad Guidelines of the Economic Policies of the Member States and the Community

drawn up in conformity with Article 103 (2) of the
Treaty establishing the European Community

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Broad Guidelines of the Economic Policies of the Member States and the Community

1. Main priorities: high employment and a successful EMU

The introduction of the euro on 1 January 1999 marks a new phase in the process of European integration and in the conduct of economic policy in the Community.

The vigorous and credible implementation by the Member States, especially over the last two years, of policies aimed at achieving a high degree of sustainable economic convergence in the Community has yielded tangible results.

Firstly, reflecting these remarkable convergence efforts and results, the Council of the European Union, meeting in the composition of Heads of States or Government, decided on 2 May 1998 that eleven Member States fulfilled the necessary conditions for the adoption of the euro.

Secondly, these efforts have led to the establishment of a macroeconomic policy mix conducive to growth and employment.

However, until now, insufficient progress has been made in reducing unemployment in the Community.

Since the summer of 1997, when the previous Broad Economic Policy Guidelines were adopted, an increasingly robust and more broadly based economic recovery has taken hold in the Community, in a context of historically low inflation. With spare capacity available and with prospects for healthy growth in investment, especially in equipment, solid growth should be able to take place without encountering capacity constraints or generating inflationary tensions, if, as expected, wage developments continue to be appropriate. Monetary conditions may thus remain favourable for growth and employment for an extended period. In addition, the underlying economic fundamentals are sound and improving continuously, demand prospects are brightening and confidence is strengthening further.

The impact on Community growth prospects from the financial and economic events in Asia appears limited, provided firstly that the crisis neither deepens nor extends to other countries in the region and, secondly, it is properly handled. Although the Asian events will exert a modest dampening impact on economic activity in the Community, mainly on export volumes, the easier than otherwise warranted monetary conditions and the strengthening of domestic demand will help to maintain the growth momentum.

Against the background of a further strengthening recovery, employment could increase moderately, leading to a slight reduction in the unemployment rate up to 1999 in the EU as a whole. This would constitute a first, albeit modest, step in the direction of the objective of a high level of employment aimed for in Article 2 of the Treaty of Amsterdam.

The level of employment in the EU (presently about 60 per cent of the working age population) is low. This is the result not only of high unemployment (about 18 million people in 1997) but also of poor employment prospects over long periods which have discouraged many people to seek a job, many of whom are beneficiaries of other social security provisions. Thus, rising employment has to absorb not only the unemployed but also a rising participation rate and still some demographic increase in the population of working age.

In the short run, the present degree of non-employment is undoubtedly a weakness and the source of large social, economic and budgetary costs. But the labour reserve associated with it also represents a very important growth potential beyond the growth coming from labour productivity increases and irrespective of the pace of the latter. The utilisation of this potential over the medium and longer term would greatly alleviate the burden on Member States' public finances and social security systems, helping to fight efficiently against poverty and social exclusion and thus facilitating the safeguarding and development of common European social values, as well as the reduction of tax pressure both on companies and on individuals. Furthermore, the very nature of most of the new employment opportunities would also make the transition towards a more environmentally friendly production mode significantly easier.

For economic policy, the tasks are to set the conditions for (i) a further strengthening of the recovery and (ii) its transformation into a non-inflationary, self-sustaining, high economic growth process over the medium and longer term -- a prerequisite for substantially and durably higher employment. This will require a strengthened programme of macroeconomic and structural policies and a determined implementation of the 1998 Employment Guidelines to address a number of key challenges while allowing the EU economies to better adapt to changing circumstances in the years ahead.

The introduction of the euro will not in itself solve the Union's unemployment problem. But in fulfilling the above-mentioned tasks, the move towards Stage 3 of economic and monetary union (EMU) can make a substantial contribution. This is true not only for the countries adopting the euro but also for the other four Member states if -- as expected -- they continue their convergence efforts.

The stability framework of EMU will contribute to the maintenance of a policy mix that is favourable to growth and employment.

In the *macroeconomic* field, governments and social partners should each make all the required efforts for avoiding a conflict with the stability objective of the common monetary policy. Under such conditions, monetary policy has no reason for being restrictive.

Simultaneously, *structural* policies and reforms of the product, service and labour markets are required to facilitate a tension-free growth process, to reinforce competitiveness, to increase the labour content of growth and to make growth more respectful of the environment.

Only if this policy strategy is pursued with resolve by all actors and if its implementation is well co-ordinated in line with the Luxembourg European Council resolution, will EMU -- as called for in Article 2 of the Treaty -- reap its full benefits as a mean of achieving the overall objectives of the Community, including the promotion of sustained and non-inflationary growth respectful of the environment, a high level of employment and rising living standards.

2. Price stability

Price stability is an essential requirement for realising sustained medium-term economic growth. Following impressive progress in recent years, the Community has achieved price stability in a sustainable manner. It is necessary that all policies are predictable, credible and consistent with durable price stability.

In the prospective euro-area, where the average inflation rate has fallen to below 2 per cent, all participating Member States need to conduct their economic policies with a view to maintaining price stability at the euro-zone level, thereby allowing for monetary conditions conducive to growth. They also need to avoid too wide inflation differentials that would create competitiveness problems.

Price stability has also been achieved in Denmark, Sweden and the United Kingdom. The task is to consolidate this inflation performance over the medium term. In Denmark, it will be essential to preserve price stability in the light of several years of growth above trend and a tightening labour market. In Sweden and the United Kingdom, inflation in recent years has been low compared to the historical experience. These two member states have to continue their efforts in monetary and economic policies in order to deliver sustained price stability. In the UK, in particular, the government has stated that it will monitor its inflation target in the light of the practices of the European Central Bank.

Greece has made substantial progress towards price stability in recent years. Together with the budgetary consolidation efforts implemented over recent years, this allowed the entry of the Drachma into the ERM in March 1998. ERM membership will help to improve further its inflation performance. Reinforced efforts are needed, however, to contain the inflationary consequences of the marked devaluation of the Drachma and to achieve price stability as soon as possible.

3. Growth and stability-oriented macroeconomic policy mix

In the macroeconomic field, it is essential that Member States remain committed to pursuing the growth and stability-oriented strategy recommended in the previous Guidelines and which has started to bear fruit. This strategy contains three essential ingredients:

- a stability-oriented monetary policy;
- sustained efforts to achieve and maintain sound budgetary positions consistent with the Stability and Growth Pact;
- nominal wage trends consistent with the price stability objective; at the same time, real wage developments with respect to increases in productivity should take into account the need to strengthen the profitability of investment and to raise living standards.

Indeed, the more the stability task of monetary policy is facilitated by appropriate budgetary measures and wage developments, the more monetary conditions, including exchange rates and long-term interest rates, will be favourable to growth and employment.

The overall macroeconomic policy mix *at the euro-zone level* will result essentially from the interaction of the common monetary policy on the one hand with the average budgetary developments and wage trends in the participating countries, on the other. This overall policy mix will be favourable to growth and employment if all actors and group of actors behave according to the guidelines summarised above. In the framework of the Treaty, supplemented by the Stability and Growth Pact and the Amsterdam European Council resolution on "Growth and Employment", the responsibilities are distributed as follows.

(i) The single monetary policy in the euro-area will be under the responsibility of the independent ECB and ESCB. In conformity with Article 105(1), the primary objective of monetary policy will be to maintain price stability and, subject thereto, to support the economic objectives of the Union, including, in particular, sustained, non-inflationary, growth and a high level of employment, as laid down in Article 2 of the Treaty.

(ii) Budgetary policies will remain the responsibility of national governments but will be subject to the rules of the Treaty (Article 104 to 104c) and the Stability and Growth Pact, which emphasises the need to have a budgetary position close to balance or in surplus in normal economic conditions and clarifies the key Treaty provisions on budgetary policy. National governments will have to co-ordinate their budgetary policies in the framework of the Broad Economic Policy Guidelines.

(iii) Wage setting will remain the responsibility of the social partners at the national, regional, sectoral or even at a more decentralised level following their respective traditions. As underlined in the Amsterdam Resolution on "Growth and employment", the social partners are responsible for reconciling high employment with appropriate wage settlements and for setting up a suitable institutional framework for the wage formation process. Since they have an important bearing on the overall macroeconomic policy mix, aggregate wage developments are of general interest.

In the framework of the overall macroeconomic policy mix of the euro-zone, *the policy mix in each participating country* will depend also on its specific economic conditions and on its specific budgetary and wage developments. In order to ensure an appropriate policy mix both in the whole euro area and in each participating Member State, macroeconomic policies will form an integral part of the strengthened multilateral surveillance and co-ordination of economic policies as agreed at the Luxembourg European Council.

For the countries that do not initially adopt the single currency, the need for stability-oriented and convergent macroeconomic policies will be equally strong, especially if they participate in the ERM2, as countries with a derogation are expected to. The strong economic and monetary interdependence between the euro-area countries and the Member States not as yet adopting the euro and the need to ensure further convergence and a smooth functioning of the single market, will require that all Member States are included in the co-ordination of economic policies.

4. Monetary policy and exchange rates

A smooth changeover to the euro on 1 January 1999 is required to ensure that EMU is launched in the most favourable circumstances. To this end, monetary policy co-ordination between the Member States adopting the euro will need to intensify in the remaining months of 1998. In particular, a co-ordination of national monetary policies can be expected so as to ensure that official interest rates converge smoothly to a common euro-area rate, which will apply from the beginning of EMU, and that market exchange rates converge to the pre-announced bilateral conversion rates. This will also ensure continuity between national interest rates and the euro rate and will avoid uncertainties concerning euro conversion rates. If interest-rate and exchange-rate convergence is to be assured ahead of EMU, it is inevitable that euro-area considerations will become more important as determinants of national monetary policies in the participating Member States.

The common euro-area interest rate will depend upon the prevailing economic conditions and expectations when EMU is launched but it is certain that the ECB will set this rate so as to maintain price stability in the area as a whole. As the euro-area interest rate will be consistent with price stability, interest rate convergence among the Member States will not present any problems for the euro area as a whole. However, the euro-area interest rate is unlikely to match exactly the initially different cyclical conditions in each of the participating Member State economies. Accordingly, convergence to the single rate -- and to a lesser extent convergence in exchange rates to the pre-announced bilateral conversion rates -- might require an adjustment of the policy mix, notably through budgetary policy measures (see Section 5.2).

The Member States not adopting the single currency from the outset retain competence in their national monetary policies but, in accordance with the Treaty, are expected to treat their exchange rates as a matter of common interest. The ERM2 will provide a useful framework for monetary relations between the pre-ins and the euro area from 1999 onwards and will support their convergence efforts ahead of adopting the euro. While participation in the ERM2 will be voluntary, the pre-ins would be expected to join.

5. Sound and efficient public finances

5.1. General guidelines

Following a peak of 6.1 per cent of GDP in 1993, the actual government deficit in the Community as a whole has fallen steadily, reaching 2.4 per cent of GDP in 1997. In the EC on average, the budgetary adjustment was entirely made up by a reduction in government spending in GDP (from 52.4 per cent in 1993 to 48.7 per cent in 1997). This remarkable outcome is essentially the result of determined consolidation efforts in all of the Member States, in particular in 1997, assisted by stronger economic growth and falling interest rates.

On the basis of budget measures decided upon until mid-April 1998, the net borrowing of general government *in the Community as a whole* is likely to be reduced further to just below 2 per cent of GDP in 1998 and, on the basis of unchanged policies, to decline further to 1.6 per cent in 1999. However, the government budget deficit adjusted for cyclical influences is expected to post only a modest decline over the period under review. *In the prospective euro area*, the government deficit stood at 2.5 per cent of GDP in 1997 and could drop, with unchanged policies, to 2 per cent of GDP in 1999. A strict implementation of the country-specific budgetary guidelines stipulated in Section 5.2 could reduce the budget deficit to below 1.5 per cent of GDP in 1999 in the euro zone as a whole.

Despite the achievement of sustainable public finances in virtually all Member States, additional progress is required in most countries in compliance with the Stability and Growth Pact's medium-term objective of budgetary positions close to balance or in surplus. This requirement holds for all Member States but in particular for those adopting the euro as of January 1999 for the following reasons.

(i) Sound budgetary policies, by fostering low and stable inflationary expectations, will facilitate the task of the single monetary policy in maintaining price stability. In the present conjuncture, a further scaling back of government deficits will contribute to the sustainability of the economic recovery because it will allow continued favourable monetary conditions, thereby supporting investment and alleviating capacity constraints.

(ii) In many countries, public finances have not yet regained the necessary room for manoeuvre to cope with adverse economic developments. Since after the introduction of a single currency, the adjustment to adverse cyclical developments and country-specific disturbances will to an important extent rest with budgetary policy, it will be of paramount importance to ensure that the automatic stabilisers will be able to fully play their role. Furthermore, sound budgetary policies will in all likelihood also increase the effectiveness of the automatic stabilisers. Proven budgetary discipline will strengthen the confidence of economic agents that a rising deficit during a recession will not permanently disrupt the public finances, thereby avoiding any adverse effects emanating from the financial markets.

(iii) Sound budgetary positions will help to keep long-term interest rates at a low level, thereby generating a crowding-in of private investment. Since in such circumstances governments no longer absorb private saving, but make a positive contribution to savings in the economy, the increase in the investment rate can - other things being equal - take place without pressures on the balance of payments and long-term interest rates.

(iv) Finally, budgets close to balance or in surplus will allow a speedy reduction in the still relatively high public debt ratios in many countries and hence to reduce the debt service burden. This in turn will facilitate the needed restructuring of government spending towards more productive uses and the lowering of taxes and social security contributions, while making the taxation system more employment friendly. It will also help to prepare for the budgetary consequences of population ageing.

Against this background, it is essential that Member States provide assurance regarding the continuity of budgetary adjustment. To this end, Member States should commit themselves:

(i) to fully implement their 1998 budgets, thereby avoiding any backsliding; a strengthening of economic growth beyond the current expectations should be applied to step up deficit reduction;

(ii) to seize the unique opportunity offered by the present favourable economic conditions, especially in terms of output growth and further declines in debt service costs, to target ambitious budgetary objectives aimed at achieving as soon as possible positions close to balance or in surplus;

(iii) to advance the submission of their stability and convergence programmes with a view to enabling the Commission and the Council to assess all these programmes, including the overall budgetary stance and the policy mix in the euro area, at the start of Stage 3 of EMU;

(iv) to assure, where appropriate, a further steady decline in public debt and an appropriate maturity structure with a view to reducing the vulnerability of their public finances to adverse developments in interest rates.

The timing, scale and composition of budgetary adjustments are important in determining whether they will be successful in having a durable impact on the government's budgetary position and in improving economic dynamism, competitiveness and employment. Although they will need to be tailored to country-specific conditions, previous guidelines exercises identified a number of general principles. The present guidelines reaffirm and build upon these principles.

(i) Budget deficit reductions should be achieved through expenditure restraint rather than through tax increases.

(ii) In cases where government deficits and/or government debt-to-GDP ratios are still relatively high, priority should be given to a swift reduction of deficits. A continued decline in the share of government spending in GDP will accelerate deficit reduction and put it on a more sustainable basis.

(iii) Budgetary consolidation needs to be accomplished in a socially balanced way and without impinging on the quality of government services. It must be directed towards increasing the effectiveness and the efficiency of government spending. In this respect, measures should focus on better controlling or reforming public consumption, public pension provisions, health care, passive labour market measures and subsidies. Furthermore, in recent years, there has been a tendency for government investment to be reduced relative to GDP, although part of this reflects a shift towards the private financing and operation of public infrastructure investment. To the extent possible and without threatening the necessary further reduction in government deficits, spending on investment in infrastructure as well as on other productive activities such as on human capital and active labour market initiatives, should be favoured. Such a restructuring is likely to lead to an increase in the employment rate and/or to a reduction in the number of people of working age receiving social transfers, thereby helping to improve budgetary positions over the medium term.

(iv) In order to improve economic efficiency and to promote economic dynamism, a reduction in the overall tax burden is desirable in most Member States, but it should be contingent upon further steady progress towards sound budgetary positions. In conformity with the 1998 Employment Guidelines, Member States are recommended to reduce the burden of social security contributions or the tax wedge as a whole, in order to reverse the trend towards an increase in the tax burden borne by employed labour, especially at the lower end of the wage scale. It is essential that the timing and modalities of efforts to reduce the tax burden on labour are decided upon with a view to maximising their employment effects while fostering sound public finances and preserving the sustainability of social protection systems through better controlling government spending and/or identifying alternative financing sources.

5.2. Country-specific guidelines

(i) Euro-zone Member States

In *Belgium*, favourable economic growth conditions have contributed to bringing forward by one year the budgetary targets set in its convergence programme. Efforts are still needed, however, to ensure that the government's commitment to maintain the primary surplus at 6 per cent of GDP over the medium term is realised, thereby securing a fast decline in the debt ratio, which is still at a very high level. A tight control needs to be exerted further on transfers to households and especially on health care spending.

Germany needs to reduce its government deficit in the coming years. Subsidies, transfers to households and government consumption need to be restrained further. Additional efforts to cut spending are also needed if the government's aim of reducing the expenditure ratio by the year 2000 to its pre-unification level of 46 per cent of GDP is to be realised. Germany needs to step up its budgetary adjustment to put its debt ratio firmly on a declining path and to swiftly bring it back below the 60 per cent of GDP reference value in the near future.

In *Spain*, maintaining the current budgetary stance would allow the deficit to come down in the coming years due to the favourable economic growth conditions. Spain would, however, still need to undertake an additional effort to improve the budgetary position further to the medium-term target of a budget close to balance or in surplus. A further tightening of fiscal policies in Spain is also needed to prevent the risk of overheating. Spending needs to be controlled further if the government's aim of reducing the expenditure-to-GDP ratio to just below 42 per cent of GDP by the year 2000 is to be realised.

In *France*, the medium-term budgetary strategy must be made clear. Budgetary adjustment efforts should be stepped up to bring the deficit clearly below the 3 per cent of GDP reference value in 1999 and pursued beyond that year in order to respect the medium-term obligations of the Stability and Growth Pact. These consolidation efforts are also needed to stabilise the debt ratio and to put it on a downward path in the very near future. When bringing about the deficit reduction, efforts must be made to continue the tight control of transfers to households and government consumption.

In *Ireland*, the government budget is expected to show increasing surpluses in the coming years and the debt ratio is expected to fall below 60 per cent of GDP in 1998 and to continue declining thereafter. In view of the present strong growth of the economy and the possibility of overheating, any revenues received over and above those anticipated in the 1998 budget should be used to raise the budget surplus. Moreover, a tight fiscal stance is required in Ireland to reduce the risk of overheating, namely in 1999, and such a stance should not be jeopardised by any further tax reductions.

After having successfully reduced its government deficit to below the 3 per cent of GDP reference value in 1997, *Italy* needs to step up further its budgetary consolidation efforts. Efforts are needed to ensure a rapid decline in the deficit ratio through an appropriately high level of the primary surplus over the medium term. Such developments in the overall deficit, reinforced by privatisation revenues, should secure a continued decline in the debt ratio.

Luxembourg is expected to keep a budget surplus in the coming years, while its debt ratio will remain at a very low level.

The Netherlands must not allow its current budgetary position to deteriorate. Given the favourable economic growth conditions expected in the coming years, the deficit should be brought down further. The budgetary stance should therefore not be relaxed and the government deficit should not be allowed to start increasing again. Budgetary adjustment should be maintained to ensure a further continuous decline in the debt ratio.

Austria should continue its consolidation efforts in the coming years in order to achieve the target of a budgetary position close to balance or in surplus over the cycle. Austria needs to exert a tight control on its budget in order to ensure that ongoing structural reforms in the pension system and the adaptation of family taxation to comply with a recent Constitutional Court ruling, do not lead to a build-up of pressures on the budget. Further budgetary consolidation is also needed to put the debt ratio firmly on a downward path.

Portugal should seize the opportunity presented by the favourable economic growth conditions in the coming years to rapidly bring down its deficit to a position close to balance or in surplus, as required by the Stability and Growth Pact. This would also help to reduce the risk of overheating. Budgetary adjustment should increasingly focus on the expenditure side, instead of relying predominantly on revenue increases and reductions in interest payments. The debt ratio is expected to fall to 60 per cent of GDP in 1998 and to continue declining in the coming years.

In *Finland*, the government budget is expected to turn into surplus in 1998 and increasing surpluses are aimed for in the coming years. Finland plans to introduce an income tax reduction in 1999. This measure should be implemented in such a way that the process of further budgetary adjustment is continued.

(ii) Member States not adopting the euro as of January 1999

Denmark is expected to tighten further its budgetary stance and to increase its budget surpluses in the coming years. Tax revenues will remain buoyant, while government investment will be reduced further. Given the increasing budget surpluses and the sale of financial assets by the government, the debt ratio is expected to fall below 60 per cent of GDP in 1998 and to continue declining in the coming years.

Greece has made substantial progress in reducing the large imbalances in its public finances over recent years but its deficit remained at 4.0 per cent of GDP in 1997 and the high government debt ratio has only been reduced during one year so far. Greece should continue its budgetary consolidation efforts notably through the rigorous implementation of the measures announced by the government when the drachma joined the ERM, in order to secure its smooth and orderly participation in the ERM. These measures include a further reduction in primary expenditure, the reform of the social security system in the medium term, extended privatisation plans and the restructuring of large public enterprises.

Sweden plans to continue its budgetary adjustment efforts, although at a gradually easing pace, and to realise increasing surpluses in the coming years. Sweden is aiming for a budget surplus of around 2 per cent of GDP over the cycle. Budgetary adjustment should focus on controlling expenditure, especially transfers to households, while the burden of taxation on the economy needs to be alleviated.

In the *United Kingdom*, the deficit is targeted to be reduced further towards a budgetary position close to balance or in surplus by the end of the decade. To achieve this position, the United Kingdom should rigorously implement the announced budgetary measures. Government expenditure should continue to be controlled tightly. The conduct of budgetary policy in the United Kingdom should also take into account the need to bring about the envisaged overall stability conditions for the UK economy.

6. Wage developments

The evolution of aggregate wages and wage differentials has substantial implications for inflation, growth, employment and the employment-content of growth. In EMU, with the single monetary regime, the link between wages and employment will become more evident and stringent. On the other hand, the credible and stability-oriented macroeconomic framework will foster adequate wage behaviour.

For wage developments to contribute to an employment-friendly policy mix, the social partners should continue to pursue a responsible policy course and conclude national and regional wage agreements in line with the following general rules.

(i) In the euro area, aggregate nominal wage increases must be consistent with price stability. This implies that wage settlements must embody the inflation objective pursued by the European Central Bank. The known and credible price stability objective will facilitate the continued respect of this rule. Wage increases in the whole euro area that are incompatible with price stability will inevitably lead to a tightening of monetary conditions in the euro zone, with adverse effects on growth and employment. Excessive nominal wage increases in a country or region will not necessarily exert a significant impact on inflation in the entire monetary union but, through their effect on unit labour costs, they will worsen competitiveness and employment conditions in this country or region.

(ii) Real wage increases with respect to labour productivity growth should take into account the need to strengthen, and subsequently maintain, the profitability of capacity-enhancing and employment-creating investment, whilst supporting the purchasing power of wage earners. This implies that in countries where overall labour productivity growth is slowing down, due to policies aimed at increasing the employment-content of growth (e.g. a reduction in working time and a cut in non-wage labour costs at the low end of the wage scale), the scope for macroeconomic real wage increases will be reduced. For improved profitability to result in higher investment inside and not outside the Community, it is essential to forge an investment-supportive environment in terms of demand developments, labour market conditions, taxation and the regulatory framework.

(iii) Wage agreements should better reflect differentials in productivity levels according to qualifications and skills, regions and, to some extent, sectors. In this context, the social partners should consider the introduction of entry wages for the young, low-skilled or long-term unemployed, whose effects would be enhanced by measures to promote the employability and the adaptability of the labour force.

(iv) "Wage imitation effects" need to be avoided, implying that labour cost differences between Member States should continue to reflect discrepancies in labour productivity. Due to the existence of a single currency, differences in wage levels between Member States will become more transparent. This may lead to a certain increase in labour mobility but may also give rise to wage claims in lower-wage countries to close the gap with higher wage countries. An increase in wages faster than warranted by productivity levels in a country would lead to a deterioration in competitiveness and investment profitability and therefore to reduced attractiveness as a production location. The country's export performance would suffer, investment would be deterred and unemployment would increase.

These requirements for adequate wage behaviour apply in particular to the countries adopting the single currency, but also to the other Member States, as they should be equally committed to growth and stability-oriented policies. Compliance with these requirements does not imply, however, that wage developments should be uniform across the euro-area. There are likely to be differences in productivity growth and thus in the available room for real wage developments. Moreover, differences in labour market situations and economic conditions need to be taken into account. In EMU, wage adjustment will need to play a more important role in the adjustment to changing economic circumstances, especially in the case of country-specific disturbances, thereby requiring a higher degree of flexibility in the wage formation process.

Since the social partners are primarily responsible for achieving wage developments compatible with the achievement and maintenance of high employment, thereby playing an important role in achieving an appropriate macroeconomic policy mix, it is essential to strengthen the social dialogue at all the appropriate levels. At the national level, governments may have to take a stronger interest in fostering dialogue and in promoting understanding of the policy strategy developed in the Broad Economic Policy Guidelines. At the Community level, the Commission

will continue to develop the social dialogue, notably on macroeconomic policy issues. Furthermore, in the framework of the strengthened economic policy co-ordination, there is a need to establish credibility and a climate of confidence between the major policy actors which could be reinforced by a regular dialogue between the social partners on the one hand and the authorities responsible for budgetary and monetary policies on the other.

7. Structural policies for growth and employment

Structural policies have a primary role to play in fostering economic growth, restoring competitiveness and raising employment levels. Their key role is to help ensure a tension-free macroeconomic growth process, to reinforce the EU's competitiveness, to increase the employment-content of growth and to make growth more respectful of the environment. However, to reach their full effectiveness, they must be coherent with the pursuit of sound macroeconomic policies. In this respect, it is essential that the budgetary costs of structural reform are kept under control and do not jeopardise the achievement of sound budgetary positions. Their economic benefits also emerge only gradually over time and they are clearly more efficient in a context of higher economic growth.

Given insufficient progress in the implementation of structural reforms in product, service and, especially, labour markets in most Member States, continued and intensified efforts are required to remove often deeply seated structural deficiencies. This need is made all the more pressing by the introduction of a single currency. Member States' adjustment to country-specific economic disturbances will have to rely to a considerable extent on the flexibility and adaptability of their markets for products, services and factors of production. EMU will also intensify competitive pressures on enterprises because of increased price transparency and the elimination of possible exchange rate changes within the euro zone.

Failure to make resolute headway in bringing about a greater flexibility of the Member States' economies will have serious consequences; economic growth will not be sufficiently bolstered, employment levels will not be significantly raised and progress towards greater economic and social cohesion among the Member States will be jeopardised. On the other hand, the introduction of the euro is itself likely to act as a catalyst for structural reform. The single currency will unleash competitive forces that will strengthen the incentives for structural reforms, thereby improving the chances for reducing unemployment. Just as the immediacy of the Maastricht exigencies galvanised support for macroeconomic adjustment, the commitment to a properly functioning EMU and to durably reduce unemployment should now help to mobilise support for a programme of mutually reinforcing structural measures in areas such as taxation, social protection systems, and product and labour markets, which would aim at enhancing both market efficiency and social cohesion.

8. Product, service and capital markets

In order to safeguard and promote the EU's competitiveness, employment and living standards in a world of free trade and constant technological change, it is essential that Member States and the Community intensify their efforts to improve the efficiency of product, service and capital markets. These efforts should focus on four major areas.

(i) Reforms to perfect the Single Market

Improvement in the functioning of the Single Market is of paramount importance for a successful EMU. Despite considerable progress, a number of significant problems remain. The legislative framework of the Single Market remains incomplete, mainly due to the lack of full implementation of EU directives at national level. Efforts to reduce the degree of non-implementation of Single Market directives should be pursued particularly in Portugal, France, Austria, Italy and Belgium where the implementation deficit ranges between 6 and 7.5 per cent. Recognising this problem, the Commission and the Member States agreed an Action Plan for the Single Market in June 1997 committing the Member States to clear away the most serious remaining legislative gaps by 1 January 1999. Among the areas requiring further action, public procurement and mutual recognition deserve particular attention.

Efforts should now focus on ensuring the prompt implementation of the Action Plan and on monitoring the progress towards an effective Single Market. To this end, the Single Market Scoreboard is being developed for regular six-monthly publication. Furthermore, in its conclusions, the Luxembourg European Council stressed both the importance of paying full attention to those national economic developments and policies which may hinder the smooth functioning of the Single Market and the need for policy co-ordination to aim also at fostering tax reform in order to raise efficiency and to discourage harmful tax competition. In this area, the treatment of tax incentives should be consistent with Community rules for State aids and Member States compliance with principles of fair tax competition should be monitored. This is one of the main tasks of the Follow-up Group, which was established on 1 December 1997.

The Single Market and overall globalisation exert a strong pressure to improve competitiveness, but the latter is also linked to national or Community policies in the field of R&D and, notably, the information society. To this end, it is essential to implement swiftly those actions programmed in the Action Plan which promote innovation and a wide diffusion of new technologies. The logistic environment of firms needs also a strengthening of efforts in TEN and national infrastructure projects both in keeping an adequate share of public investment in overall public expenditure and by searching for joint ventures with the private sector where appropriate. Efforts should also focus on encouraging an enterprise culture and promoting entrepreneurship, a key factor in stimulating growth, employment and competitiveness in the Community.

(ii) Reforms to enhance competition

In the area of competition policy, the Commission has recognised the need to streamline and decentralise anti-trust enforcement in order to enhance its effectiveness and reduce the costs imposed on enterprises. Member States should also make an important contribution towards achieving the objective of a more efficient enforcement of anti-trust rules by revising their laws so that the national competition authorities can apply anti-trust policy effectively and by reviewing their competition laws with a view to eliminating any unnecessary burden on businesses.

For state aids, there is a need for the Commission to strictly control them and for the Member States to exercise rigorous self-discipline. This discipline should be particularly welcome in those Member States where state aids as a percentage of GDP are above the Community average (Germany, Luxembourg, Italy, Belgium and Greece) or where ad hoc aid for rescue and restructuring is relatively large, resulting in greater distortionary effects (Portugal, France, Italy and Spain). These state aids may create artificial cost advantages for low-tech, low-demand sectors. In the Community, this has contributed to maintaining a specialisation in weak-demand sectors, reducing its competitiveness without succeeding in creating or maintaining employment. Part of the resources devoted to the financing of these aids could therefore be diverted towards other structural policies aimed at promoting innovation, accumulating human capital and boosting competitiveness and productivity. This would improve the capacity of European economies to meet the challenge of a fast-moving world of constant technical change.

(iii) Regulatory reforms

An adequate regulatory framework is a pre-condition for boosting productivity growth and raising the competitiveness of European firms. In part reflecting an excessive regulatory burden, productivity, relative to the manufacturing sector as a whole, in high-tech sectors, such as aerospace, pharmaceuticals, precision instruments, has been growing slower in the Community than in the United States. Governments and the Commission therefore have the responsibility to continuously review existing regulations to assess their appropriateness and to reduce the costs of implementing and monitoring these regulations and to increase their transparency and enforceability. This also holds for environmental legislation and regulation, which should be incentive-based so as to allow economic agents to achieve well-defined environmental objectives in a cost-effective way. As there are still wide disparities in regulatory practices between countries, a benchmarking approach to the identification of the best regulatory practices could lead to a significant improvement in the regulatory environment of enterprises. This initiative could be co-ordinated by the Commission on the basis of contributions from the Member States.

Administrative regulations and cumbersome procedures tend to weigh especially heavy on small and medium-sized enterprises, particularly during the start-up phase. The outcome of the BEST Task Force highlights priority areas for action in this regard. Therefore, a first area where this benchmarking exercise could be launched is the administrative regulations for the start-up of business. Similarly, identifying and removing any remaining regulatory barriers to the development of venture capital and new financial products, particularly those that may assist in the financing of SMEs, should be a priority.

Special attention needs also to be paid to job creation at local level in the social economy and new activities linked to the needs not yet satisfied by the market, which have an important spillover effect both in terms of economic activity and social cohesion. To exploit fully the opportunities offered in these areas, a more favourable regulatory and fiscal framework need to be developed.

(iv) Financial markets

EMU will bring important changes to European financial markets. From 1 January 1999, the ECB will define and implement its monetary policy in euro. The interbank markets, money markets, foreign exchange and capital markets of the Member States in EMU will switch to the new currency. All new issues and existing stocks of government debt of the Member States adopting the euro will be denominated in euro and an increase is expected in the issuance of private-sector debt and equity in euro. Private sector usage of the euro will also be encouraged by the facility for cross-border payments through the TARGET system and through the harmonisation of market conventions. EMU will result in the emergence of large and highly liquid euro financial markets, which should provide an important stimulus to economic growth in the euro area. To this end, it is important that the national authorities take the necessary measures to remove legal and financial obstacles to market integration. As segmentation between Member States' financial markets diminishes in EMU, any inefficiency will become more apparent amid intensified competition between euro-area financial institutions. Moreover, the new euro financial markets are likely to prove attractive to financial institutions from outside Europe. It is essential, therefore, that operators should be fully prepared for EMU if the potential of the new euro financial markets is to be fully realised.

For these reforms to be highly effective, they need to be co-ordinated at the Community level and be closely monitored through a regular multilateral surveillance, thereby complementing the on-going macroeconomic multilateral surveillance. To this end and to ensure steady progress with economic reform, Member States and the Commission should submit short annual reports setting out their policies aimed at making their product, service and capital markets more efficient. These reports will provide an input to the Broad Economic Policy Guidelines, starting from next year. The Commission will also elaborate an extended scoreboard with indicators of effective market integration, including price differentials, and implementation of Single Market measures.

9. Labour markets and investment in knowledge

A durable reduction in the presently high levels of unemployment and non-employment in the Community is possible. It requires however a vigorous and unremitting use of a broad range of mutually reinforcing policies with success often emerging only over the medium to longer term. Macroeconomic policies, in interaction with structural policies, should ensure the realisation of a protracted period of strong, non-inflationary growth supported by capacity-enhancing investment. The required policies in this respect form the essence of the present and previous Broad Economic Policy Guidelines. But solving the Community's unemployment and non-employment problem will require a simultaneous and comprehensive modernisation of the Community's labour markets with a view to increasing the employment-content of growth and ensuring the employability of the labour force. This second component of the Community's strategy for high employment was developed in the Luxembourg Employment Guidelines.

The Employment Guidelines -- based on the four pillars of improving employability, developing entrepreneurship, encouraging adaptability of businesses and their employees and promoting equal opportunities -- will be implemented via the National Action Plans (NAPs) for employment. Adapted to the specific national circumstances, these plans must integrate the employment measures in a strategy of sound macroeconomic policy including budgetary consolidation in conformity with the requirements of the Growth and Stability Pact. Furthermore, they must provide a vehicle for action aimed at both reducing mismatches in the labour market and at enhancing the responsiveness of firms to economic change. In this way, the NAPs will serve as an important policy tool directed towards reinforcing the Community's growth and employment potential and as such they will undoubtedly form an important ingredient of future Broad Economic Policy Guidelines.

Member States' actions should put the emphasis on a preventive strategy, which focuses on active policies to increase the supply of an adequate, educated and trained labour force. Such active measures need to be combined with efforts to increase incentives to seek and create jobs via a review of tax and benefit systems.

(i) Active labour market policies

Over a 5-year period, Member States must tackle youth unemployment and prevent long-term unemployment by offering every unemployed young person and adult a new start before they reach 6 and 12 months of unemployment respectively. This requires increased resources for the employment services to perform efficient job searching and job matching services. Such measures should be combined with accompanying measures like training and in some cases wage subsidies and reductions of social charges, especially for the low skilled. Around 15-30 per cent of all unemployed find a job within one year. It will be important to concentrate the scarce resources of the employment services on the other 70 to 85 per cent that need help to find a job.

Long-term unemployment is particularly important in Belgium, Ireland, Italy and Spain, while youth unemployment is high in Finland, France, Greece, Italy and Spain. These Member States would have to make a special effort to respect the guidelines.

(ii) Taxation

For more than 15 years, the structural development of the taxation systems (tax and social security contributions) in the Member States has been unfavourable to employment. The implicit tax rate on employed labour increased from 35 per cent to over 42 per cent between 1981 and 1996 in the Community on average, whilst that on other factors of production followed a declining trend. As a result, labour taxes have driven an increased wedge between what workers receive and what firms pay. High taxes hamper economic efficiency, growth and, eventually, job creation. High labour taxes are especially harmful at the low end of the wage scale where it leads to the pricing-out of the market for low-skilled, low-pay jobs and an increase in "black market" activities.

In the medium run, the Member States should aim at reducing taxation -- in overall terms and, especially, on labour. This, however, should not jeopardise budgetary consolidation. In Belgium, France, the Netherlands, Denmark, Austria, Finland and Sweden, the tax wedge is higher than the EU average, demanding a special effort from these Member States. A significant and across the board reduction in labour taxes would imply either a strong reduction in social benefits or high budgetary costs. In the short run and with a view to assisting employment, a reduction in labour taxes, especially employers social security contributions, would be most efficient when targeted at specific labour force groups at the low end of the wage scale (young workers, long-term or low skilled unemployed) where its employment impact might be more substantial, especially when combined with active labour market measures in education, apprenticeship schemes, vocational training and re-training. To make the taxation system more employment-friendly, the possibility of shifting, in a revenue neutral way, part of the tax burden away from labour towards energy and environmental pollution needs to be examined and, where appropriate, to be actively pursued.

(iii) Welfare reform

Welfare systems need to be reformed with the aim of increasing incentives and opportunities to take up jobs and, more generally, improving the functioning of the labour market. This means switching from passive income maintenance to welfare support through work. However, in some countries, taking up a job compared to receiving benefits offers little advantage, especially for low-income earners experiencing long unemployment spells: combined benefits for unemployment, housing and childcare can in some circumstances result in *net* replacement rates of over 80 per cent in Belgium, Denmark, Finland, France, Germany, the Netherlands, Sweden and the UK.

Making work pay requires a double strategy. Firstly, acting on the benefit side, by tightening eligibility criteria, job search requirements and, in some cases, revising the time profile of benefits. Many countries, for example Denmark and the Netherlands, have had positive results in this field. However, the interaction between different benefit systems should be reviewed to ensure that it would always pay to take up a job compared to receiving benefits. Secondly, implementing reforms boosting take home pay, such as in-work benefits, negative income tax or low-wage subsidies. The UK's "welfare-to-work" opens an interesting policy avenue. More generally, benefit and tax systems should be viewed in relation to labour market regulations. Member States, especially those with relatively generous benefit systems and high employment protection resulting in a double safety net, should review their labour market legislation with a view to reconciling flexibility and security while making their benefit systems more efficient.

*(iv) **Working time arrangements***

Over the last century, Member States' economies have seen a decline in the number of weekly and annual working hours per worker. This has been an important factor in terms of social progress and welfare. Most progress in this field was made during periods of fast growth and high employment and were part of a "work versus leisure" choice. The trend is, in fact, nothing more than a distribution of productivity growth, with lower working times and less growth in real wages. A return to this secular trend when growth recovers may therefore be expected and would be quite normal and welcome as an improvement in working conditions and quality of life. A compulsory and across the board reduction in working time, however, in part prompted by the desire to increase the level of employment, may have adverse consequences and should therefore be avoided.

Conversely, where appropriate, employment could be favoured by specific measures of working time reduction at the microeconomic level where it is warranted by local conditions, involves a de-coupling of capital hours from labour hours, is negotiated by the social partners and is either reversible or can be seen as being integrated into the secular trend of reduction in working time. In this context, some initiatives suggest that measures combining a reduction of working time with job creation and fiscal advantages could entail positive results. Another approach for increasing the labour content of growth would be to encourage the maximum use of voluntary part-time and new forms of employment. The possibilities in that field are obviously very different in Member countries given the very large differences in the proportion of part-time workers that one may observe at present. In these areas, the exchange, at Community level, of experiences and best practices needs to be encouraged.

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