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WORKING PAPER

# THE ECONOMIC OUTLOOK 2002

*Economic Affairs Series*

*ECON 129 EN*

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# THE ECONOMIC OUTLOOK 2002

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(Trans European Policy Studies Association (TEPSA)).

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# EXECUTIVE SUMMARY

The first part of the study investigates the role of the European Parliament and of the new modes of governance that have been introduced in recent years in European economic policy-making. Chapter I focuses on the European level of policy-making, while chapter II analyses the impact on the national level, paying particular attention to the awareness of national actors and the functioning of macro-economic policy co-ordination. It ends with conclusions with regard to the procedures of European economic-policy making as well as the role of the European Parliament (chapter III). They concern both the European level as well as the national level of decision-making, and are the basis for some of the recommendations to the European Parliament which follow this executive summary.

In the second part of the study, the implementation of the Broad Economic Policy Guidelines (BEPGs) as well as the stability and convergence programmes of the Member States is analysed. The BEPGs and the stability and convergence programmes have been analysed together, as the stability and convergence programmes and the opinions of the Ecofin Council on these programmes feed into the BEPGs that are adopted a few months later[1]. Given the interest shown by the Members of the European Parliament when the interim report was presented to the Committee on Economic and Monetary Affairs on the 3 December 2001, the current economic situation and the outlook for the year 2002 especially after 11 September is examined more explicitly. The cross-national assessment in chapter IV refers to the general recommendations of the BEPGs, while chapter V takes up the country-specific findings. The cross-sectoral analysis of the country-specific recommendations has been limited to the presentation of key developments in the Member States, covering the four policy areas of the BEPGs 2001: budgetary policy, the labour market, the product market and knowledge-based economy, and capital markets. The reports on the Member States do not address every single country-specific recommendation, instead, a summary of the implementation of the country-specific recommendations is presented in chapter VI. A number of general recommendations to the European Parliament have been drawn up on the basis of the policy implementation study presented in part II.

The third and final part of the study returns to the global economic context and examines the prospects for economic recovery in the EU (chapter VII). Furthermore, it analyses, on the basis of the criteria laid down in art. 121 TEC, the development of economic and economic policy convergence up to the year 2003 on the basis of recent forecasts (chapter VIII).

## 1. *NEW MODES OF GOVERNANCE IN EUROPEAN ECONOMIC POLICY-MAKING AND THE ROLE OF THE EUROPEAN PARLIAMENT*

Governments have created a complex set of rules that allow national and European actors both to participate in the EU policy cycle and to employ instruments that have an increasing impact on the domestic arena. However, new modes of EU governance in economic policy, such as the open method of coordination, offer little access and influence to the European Parliament in comparison with the conventional Community methods.

In the "soft" procedures for the coordination of economic policy, EU institutions other than the European Commission are involved only to a very limited extent. The European Parliament

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[1] This is a deviation from the draft structure of the study presented in the initial tender, but was considered to be more effective and avoids too many repetitions.

is granted only *ex ante* consultation and *ex post* information rights. Also in the wider context of macro-economic policy-making, the involvement of the European Parliament is distinctively different from other policy areas. The macro-economic dialogue explicitly excludes the participation of the EP, while the open method of coordination entails little or no role for the European Parliament as it is largely focussed on the Member States, with the European Commission assigned certain tasks. Nor do the procedures for preparing the new annual spring European Council meeting involve the European Parliament.

The role of the EP is thus reduced to observing and commenting on the process. As a consequence of the essentially intergovernmental procedures to make the multilateral surveillance process work, a broad European debate on the economic options as part of a deliberative democracy has been inhibited. A democratic opening-up of the policy-making procedures established to co-ordinate the macro-economic policies of the Member States needs to be envisaged.

The BEPGs do not constitute a legal obligation on the Member States to implement the recommendations. If they are to be an effective element of macroeconomic policy coordination, the BEPGs must command the attention of national actors. The timing of and procedures for decision-making at the national level of this multi-level economic governance are of critical importance in this regard. The evidence suggests a growing awareness of the BEPGs amongst national actors in recent years. Such awareness has developed hand in glove with a growing appreciation of the interrelation between the various components of (euro-zone) macro-economic policy and with the more vigorous approach taken by the European Union since medium-terms economic goals were set at the Lisbon European Council in 2000.

Even though the awareness and public acknowledgement of the BEPGs by governmental policy-makers is rising and even while some Member States have begun to adapt domestic processes in macro-economic policy making, the attention paid by national parliaments to the BEPGs as well as to parliamentary procedures to deal with the BEPGs and/or their implementation at the national level is uneven. In several Member States, the BEPGs do not play any significant role in parliamentary debates. Only in a few cases have the BEPGs been subject to party political debate, either on specific recommendations or on the coordination procedure as a whole. For the latter, the Irish debate on the Council recommendation is the best example. Public awareness and public discourse on this new form of European governance seems to be much less developed. Political debate and public discourse remain distant from the real content of the BEPG, while press coverage is, with the exception of the Irish case, almost non-existent. In this respect, the attention given to the BEPGs by the media is strikingly different from the attention given to the Stability and Growth Pact.

With regard to the awareness of national actors of the position of the European Parliament on the BEPGs in its resolutions, the evidence is not encouraging. In most Member States the resolutions play little or no significant role.

The general orientation of Member States' economic policy and the approach taken in the BEPGs are largely consistent. In some respects, the general recommendations "state the obvious" and are thus an example of "form follows function" dynamics. They contain topics "that are on the agenda anyhow". The BEPGs are recognised as containing an assessment of performance as well as offering new perspectives on policy direction. They thus inform the policy debate and certainly add value. Moreover, the BEPGs are conducive to improvements in economic policy in other EU Member States, thus generating a positive spill-over to all EU members at large, but without imposing a single "model" of policy-making.

Nonetheless, this does not rule out cases in which Member States do not strictly follow recommendations included in the BEPGs, be they general or country-specific. In cases of potential misalignment between the recommendations and Member States' policies, the recommendations are a matter for political debate or are simply ignored. Most notably in budgetary policy, but also in the other policy fields, national political choices can lead to a different prioritisation of various objectives, as the BEPGs are considered precisely as guidelines and recommendations and hence not as binding in character. A distinct divergence between the medium and long-term targets agreed upon at the European level and current Member States' policies is not evident, however. A case which is less an issue of non-compliance than one of philosophical opposition, is the medium term plan for fiscal policy in the United Kingdom.

## 2. *THE IMPLEMENTATION OF THE BROAD ECONOMIC POLICY GUIDELINES AND OF THE STABILITY AND CONVERGENCE PROGRAMMES BY MEMBER STATES*

### 2.1. **Macro-economic policies**

The EU economy manifestly slowed in the second half of 2001 and even though it is expected to avoid recession in 2002, growth is projected to be below trend. Current projections suggest that there will be slower growth in 2002 in all the developed economies. For the EU, the revised forecast for growth in 2002 is 1.4% (euro zone 1.3), with an estimate for growth in 2001 of 1.7 (euro zone 1.6). Headline inflation in the euro area is expected to have fallen by December to 2.0%, although "core" inflation is not. However, by historical standards inflation rates in most countries are very low at present. The consensus amongst forecasters is that inflation will continue to fall during early 2002, a trend that will be compounded not least if oil prices remain close to their present level.

The silver lining in the recent economic downturn is that pressures on wage inflation have, on the whole, diminished as the ability of wage negotiators to secure pay increases well above the rate of inflation will be curtailed. This will allow those Member States with relatively tight labour markets to contain inflation more easily. Not withstanding the consequences that might arise from changes to labour market regulation, unemployment is likely to rise by 0.3% both in the euro zone and in the EU in 2002.

Comparatively decisive action by monetary authorities on both sides of the Atlantic, and reasonably sound economic "fundamentals" have made it more likely that the slowdown will be short-lived. Despite the remaining uncertainties about the prospects for, and timing of, an economic recovery in the EU, there can be little doubt that the fortunes of the US economy will have an influence. The general consensus amongst forecasters is for the US slowdown to "bottom out" early in 2002 at a growth rate ranging from 0.5% to 0.7%. The recovery will be a marked one, with growth returning towards 2000 rates by 2003. The EU is expected to follow a similar course, with economic growth recovering towards rates of between 2.6% and 2.9% in 2003. From a macroeconomic forecasting perspective, the assessment of 11 September is that while geo-political turbulence may have prolonged the economic slowdown in the short-term by adding to an already uncertain economic environment, such turbulence is unlikely to harm the medium-term growth potential of the advanced industrial economies.

## 2.2. BEPGs' recommendations on budgetary policy

The BEPGs' recommendations on budgetary policy have to be reviewed in the light of the stronger than expected economic downturn in the year 2001, especially since September. For those countries which remain some way off a budgetary position of "close to balance or in surplus", the consolidation of public finances has become one of the main political priorities.

The economic performance of several Member States in 2001 has been below the expectations set out in the 2001 BEPGs. While the events of 11 September have clearly accentuated the global economic deterioration, it is important to stress that they cannot adequately account for either the downturn in the EU economy since the spring of last year, nor its marked impact on a number of Member States. Structural reform has not gone far enough to enhance in a sufficient way the euro area economy's resilience to exogenous shocks.

Due to the recent developments, many countries have missed the government fiscal balance targets as set out in the stability and convergence programmes and reiterated in the BEPGs. The average general government balance in the EU, net of UMTS-proceeds, is projected to have been -0.5% of GDP in 2001, but this reflects a somewhat better figure for the three "outs" than the twelve "ins". For the euro area, an overall deficit of -1.1% of GDP in 2001 is predicted so that the overall public finances worsened for the first time since 1993. The targets of the Member States as documented in the 2$^{nd}$ stability or convergence programme updates will therefore be missed by 0.5% of GDP for the euro zone and by 0.3% for the EU as a whole. Given the slowdown and the operation of automatic stabilisers, these cannot really be seen as unduly worrying figures, although they do break the trend toward fiscal consolidation that has characterised the period since 1993.

It is apparent that a number of those Member States singled out in the BEPGs for criticism of the targets set for the year have seen the greatest deterioration in their public finances. Other countries, however, are expected to outperform the general government balance target, although in some cases they may have been helped by the cautious assumptions upon which the programme updates were based. Other countries are also likely to diverge from the target of a budgetary position close to balance or in surplus. Had the automatic stabilisers not functioned as they did, the scale of the downturn could well have been greater. Furthermore, some Member States have reacted within the year by exercising budget revisions, mainly to prevent expenditure overshoots, and thus prevented a further deterioration of government balances. As the target is one to be achieved over the economic cycle, rather than year by year, modest deficits need not be seen as alarming.

In the preparation of budgets for 2002, those countries having already achieved positions of close to balance or in surplus have by and large followed the recommendation to preserve these budgetary positions. In Ireland and Finland especially, but also in Greece, the surpluses projected in the 2000 update have been reduced significantly with less pronounced adjustments made in other countries. None of these changes can be regarded as particularly worrying from the point of view of macroeconomic balance, to the extent that they reflect the operation of automatic stabilisers. However, they will mean that progress towards lower public debt will be postponed.

Among the four countries within the euro area which have sizeable deficits, the situation is most worrying in the case of Germany which projects a general government deficit of between 2 and 2.5%. For France, the updated stability programme foresees a broadly neutral fiscal stance over 2001-2002 (1.4% deficit), Portugal's deficit is forecast to decrease, but will still remain above 1.6% (1.8 in the programme update). As for Italy, while the Commission projects a deficit of 1.2% in 2001 and in 2002, the government aims at a reduction to 0.5% in 2002. It should be emphasised that all these projections will be sensitive to the overall performance of the EU economy as well as to policy changes. If recovery manifests itself as quickly as, and on the scale that, the forecasters anticipate, the fiscal positions of all countries should be comfortable, but if the slowdown is prolonged, the risks will be greater. In the aftermath of the slowdown, countries with existing budgetary imbalances will have to take action if they are to uphold their commitment to achieve a balanced budget or achieve a surplus by the end of the current stability programme period, i.e. by 2004.

Recommendations to make tax and benefit systems more employment friendly, taking into account the need for fiscal consolidation, and to promote the quality of public expenditure have been addressed to a certain extent by individual Member States, but the real challenge lies in securing the political will to push through these structural policies. Thus, only modest progress can be noted for several members, with the focus on reforms of tax systems, leading in most cases to a reduction of the tax burden, and on reforms of the social security sector, in particular, pensions systems.

In Sweden, the main concern with regard to the Convergence Programme is linked to the weak external value of the Swedish krona. It is undervalued according to the Swedish government and does not reflect the underlying economic fundamentals of strong growth and low inflation, although this should not be taken to mean that Sweden can be expected to join the ERM2. With regard to the United Kingdom, the possibility of conflict between the "golden rule" under the UK's Code for Fiscal Stability and the SGP medium-term budgetary requirement persists.

### 2.3. **BEPGs' recommendations on labour markets**

Employment growth decelerated substantially during the year 2001 and is projected to reach just 1.1% in the EU. The deceleration will continue in 2002 down to a projected rate of 0.2% before – under the current economic forecasts – picking up again to a rate of 1.0% in 2003. The employment rate is expected to remain more or less unchanged in 2002 at 62.1% in the euro area. Thus in 2002 and for the first time since the beginning of the Luxembourg process, job creation will virtually grind to a halt. Consequently, while the harmonised unemployment rate has declined further in the year 2001 (7.8% in November 2001 in the European Union), unemployment is likely to rise in the year 2002 by 0.3 percentage points to 8.6% in the euro zone and 8.0% in the EU. The growth in unemployment will, however, be mitigated by a slower increase in the labour force.

The BEPGs recommendations on labour markets address a variety of aspects, reflecting the still diverse labour market situation in the Member States. Overall, and given the medium-term nature of the recommendations, Member States have in many cases implemented or are in the process of implementing measures and thus can be said to have responded to the recommendations. It is, however, too early to conduct a thorough assessment of the many measures taken. Still, in most countries an intensified and more keenly targeted effort is required. Important structural weaknesses remain, especially with respect to the still high unemployment levels, in particular amongst young people. Significant gender gaps also remain and the low employment rate of older workers continues to persist in several countries.

Labour market policies in some countries have also been targeted towards the fields of childcare and other dependent care, for example by increasing child benefit rates or childcare places, or by focusing on the integration of workers with disabilities, while other countries still have to considerably improve their efforts. Not all of these actions, especially on improving female employability, are sufficient if employment is to be increased to the agreed levels. Although the rise in women's participation has been rather high in the last few years, it has relied mainly on part-time jobs. Comprehensive approaches on gender mainstreaming seem to be lacking in many Member States. In those countries, where the employment rate of older people is a particular problem, curbs on early retirement schemes have been introduced, which should keep senior citizens in the work force. However, a comprehensive approach in the direction of an active ageing policy is still missing in most Member States, while measures taken so far remain highly fragmented and incoherent. Some labour market reforms to increase labour market flexibility seem to have had less impact than expected and are in need of further improvement.

An important contribution to employment growth is the reduction of labour charges, either generally or specifically targeted at labour force segments, that is for example at low-paid workers. The tax burden on labour has decreased in several Member States, although wage or non-wage labour costs still remain high in some countries. A special focus in a number of countries has been low income levels. By reducing marginal tax rates or by supplementary public funding, also with regard to part-time contracts, employment creation should be facilitated. Efforts to reduce corporate tax rates have progressed in many countries and will provide further incentives for job-creation. All in all, tax reductions seems to have been modest, with the exception of those pertaining to low wage jobs.

With regard to labour mobility within and between Member States, not much has changed; there is little sign of any increase in the cross-national mobility of the unemployed to seek jobs.

Measures for the certification of skills and capabilities as well as training schemes should, according to the Guidelines, be linked to a coherent life-long learning strategy, but is not in place in all countries. Several Member States have to continue their efforts to provide encouragement to alternative means of training and access to employment, especially in terms of improving the quality of continuing learning efforts by implementing workable strategies.

Not all of the recommendations on labour markets, however, are in line with domestic policy preferences. Recommendations to reduce taxes are controversial in some countries and subject to more fundamental debates, even if these recommendations are issued within the context of guidance on labour market reform.

### 2.4. BEPGs' recommendations on product markets, entrepreneurship and the knowledge-based economy

The BEPGs recommendations on product markets and the knowledge-based economy promote the full implementation of the Internal Market and the reinforcement of competition and efforts to encourage entrepreneurship, as well as more investments in R&D, innovation and ICT, and in educational and training systems.

With regard to the transposition of internal market legislation, progress has been made in all but two countries in the last six months. At present, five Member States fulfil the 1.5% transposition deficit target in advance of the 2002 Spring European Council in Barcelona, one is close to this target and several others have made substantial progress. On average, the current transposition deficit record stood at 2.0% in November 2001. Only 90% of directives have been transposed in all Member States, and in some areas, such as transport or consumer policy, the transposition record is still at or well below 75%.

Developments with regard to the further opening of the public procurement market are underway in several Member States. The implementation of the public procurement directives in national law has been finalized in some Member States. The further development of on-line availability has progressed in several Member States. The value of public procurement which is openly advertised compared to the total value of public procurement has increased from 11% in 1997–1999 to 15% in 2000. Disparities between the Member States persist, however, ranging from 6% to levels above 20%. A number of countries have continued reforms in the administrative execution of public procurement, for example by centralising public procurement in one agency.

With regard to reinforced competition in network industries, the speed of the proposed liberalisation has proved to be rather slow in some cases. Some Member States have re-modelled their regulatory authorities to promote effective competition in the gas and electricity markets. On the other hand, concentration has increased in some sectors in anticipation of the emergence of a pan-European market, the consequence being that they achieve an increasingly dominant domestic position. It should be the aim of the institutions to achieve the full opening of the gas and electricity market by the year 2005 in the European Union.

With regard to both the reduction of the overall level of State aid in relation to GDP as well as with regard to the increase in transparency of State aid policies, Member States have made progress in recent years. Between 1997 and 1999, overall state aid (in relation to GDP) has been reduced by over 30% in the EU. In 1999 the EU average was about 1% of GPD, ranging from approx. 0.5% to more than 1.5%. Most Member States have gradually redirected aid to horizontal objectives that are not targeted towards specific companies, sectors or regions. In addition, ad-hoc aid has been cut substantially in recent years. With the establishment of the Commission's state aid scoreboard, peer pressure should increase on those members states that do not live up to the targets set and should prevent Member States from back-tracking on recent positive trends in these economically more difficult times.

With regard to recommendations on encouraging entrepreneurship and the creation of a business-friendly environment, evidence on the regulatory and administrative environments provides grounds for guarded optimism. Still, the regulatory and administrative environment differs significantly across the Member States. At the same time, Member States continue to introduce regulations at too quick a pace. The main priority areas identified for simplification of the regulatory environment are employment and working conditions, VAT payments and refunds, product conformity and certification for approval.

All Member States are engaged in efforts to promote entrepreneurship, both within the education system and among potential entrepreneurs. All Member States saw an improvement in their scientific and innovation performance. While some countries are clearly catching up, those who had already been leading continue to register further improvements in innovation performance. In other Member States, research and technological development and innovation are clearly losing momentum. Although the situation in the four largest EU economies is improving, it is doing so at rates that are below the EU average.

Differences among Member States also persist in the effective rates of company taxation. In the field of VAT harmonisation, progress has been rather slow, with little success from efforts to simplify the obligations of operators regarding VAT, since no agreement has been reached at Council level.

The sectors with the strongest medium-term employment growth at EU level have been and continue to be those characterised by either high technology or ICT-related jobs and/or by high knowledge intensity as reflected in the high educational levels of the workforce.

Differences in productivity growth between EU Member States are a result not only of differences in the use of ICT, but also in some cases a result of the catch-up process. Despite the recent downturn of the economy, Europe's long-term demand for skilled ICT people remains strong. Estimates indicate that the ICT skills gap will reach the amount of 1.5 million workers by 2003.

Recent figures underline the fact that although R&D investment plays an important part in the transition to a knowledge-based economy, overall spending on R&D measures in the European Union has not substantially improved in recent years. The disparity which exists between the different EU Member States has even increased, showing a considerable north-south "cleavage". In some EU Member States, targets have been set in order to increase the R&D quota, complemented by additional funds and tax incentives for businesses. For European competitiveness to be strengthened, it is necessary to raise private sector involvement contributing to a better commercialisation of R&D results and to the establishment of a European Research Area.

With regard to access and use of ICT technologies, statistics show an upward trend. There are steadily more households gaining access to the Internet, with the percentage rising from 28% in 2000 to 38% in 2001. In addition, some Member States focus on the development of a regulatory framework for the ICT sectors as well as on the development of e-Administration and further taxation incentives to foster investment.

A special focus in 2001 has been set on e-Learning measures. Industry, but also governments and administrations, are moving into this area. Efforts have been taken by some Member States to reinforce the advanced training of human resources in Science and Technology alongside initiatives to encourage co-operation between entrepreneurs and R&D systems. In this context, detailed analysis of life-long learning requirements in the knowledge-based society will entail redefining basic skills, to include, for instance, new information and communication technology.

### 2.5. BEPGs' recommendations on the efficiency and integration of the EU financial services market

The BEPGs' recommendations on capital markets refer in particular to securities markets legislation and the Financial Service Action Plan, risk capital markets, and to the prudential supervision of financial markets. Since the adoption of the BEPGs 2001, progress has been made at EU level on the Financial Service Action Plan. By mid-December 2001, twenty-five of the forty-two measures in the Action Plan had been completed, although for some of the measures the institutions are behind the schedule set by the FSAP. Member States will have to ensure that implementation of the measures at national level is carried out within the deadlines.

Significant progress has also been made in implementing the Risk Capital Action Plan, although the integration of EU financial markets is still far from complete. Venture capital investment in Europe has tripled between 1998 and 2000, and investment in early-stage venture capital has increased fourfold. However, venture capital investment as a percentage of GDP in the Member States show marked differences. Besides improvements at the supply side, more steps have to be taken to increase the demand side, making it easier especially for SMEs to create new businesses and take up new ideas. The global economic downturn as well as the current problems in the stock markets will however affect venture capital investment and, thus, will require more efforts from the Member States to continue with their efforts to reform business taxation. Progress can be noted for almost all Member States.

Special emphasis was given to the easing of bankruptcy laws in the BEPGs. While virtually all Member States acknowledged the importance of this issue, not all have actually started or completed legislative processes to implement this recommendation.

With regard to prudential supervision, several Member States have made progress in continuing either the implementation of recently adapted laws or the legislative process leading to the establishment of, mostly, integrated supervisory authorities for different financial services. However, in some countries, new prudential supervision mechanisms are controversial.

### 2.6. **BEPGs' recommendations on environmental sustainability**

The BEPGs' recommendations on environmental sustainability were part of the general recommendations. First conclusions are difficult to draw based on the variety of measures taken and fields of action proposed. Nevertheless, a modest shift towards the application of market-based instruments in pursuit of environmental objectives can be observed and support for technological innovation is being pursued by Member States. As many measures are still fragmented, the development or implementation of a national sustainable development strategy is still to be achieved by most Member States. "Mainstreaming" measures on the national level, as on the European level, are very rare.

The integration of sustainability as a major principle of economic and fiscal policy into Member States' national policies will be the key challenge for Member States in order to support innovation and investment, and to create and combine environmental as well as economic and social benefits.

## 3. *ECONOMIC AND ECONOMIC POLICY CONVERGENCE*

The objective of convergence is promoted at the EU level by the closer coordination of Member States' economic policies in general, and in particular through the BEPGs and the process of multi-lateral surveillance. Its relevance in a Union of ever-increasing economic interdependence is evident, not least for the sake of achieving of a high level of sustainable and non-inflationary growth and for the smooth functioning of EMU.

Over the last decade there has been a marked convergence in consumer price inflation towards price stability in the run-up to EMU. The average rate of inflation will remain at around 2% over the forecast horizon, while the standard deviation around this mean is expected to fall to around 0.4 percentage points. Over the longer term and even in recent memory, this reflects a picture of price stability and a state of close convergence.

By 1999, the sustainability of the government financial positions had converged towards generally more sound fiscal positions, with deficits averaging just 0.1% of GDP. The standard deviation had fallen to 2.1 percentage points. Significant progress has been made with respect to the Union's stock of public debt. The average ratio of debt to GDP stood in 1995 at 73% of GDP; but a concentrated effort by Member States pushed this ratio down to 64.4% in 1999, which was above but at least approaching the desired ratio of 60%. The standard deviation was still relatively high at 27.5 percentage points.

The global economic slowdown will lead to a deterioration in the Union's fiscal position as automatic budgetary stabilisers begin to operate and discretionary fiscal policy is relaxed. As a result, the average public deficit looks set to rise over the Commission's forecast horizon to around 0.5%. The Commission's view is largely echoed by the OECD's forecasts, both of which demonstrate convergence in that the standard deviation around the new average looks set to fall to around 1.3% in 2003. The average level of debt will fall in the opinion of both the Commission and the OECD to around 54% in 2003, thus leaving the Union well within the Maastricht definition of fiscal sustainability.

As regards exchange rate stability, Denmark is the sole member of the exchange rate mechanism of the European Monetary System. This accounts for the greater stability of the Danish krone when compared with the Swedish krona and sterling over the forecast horizon. The Danish krone looks set to remain at its ERM II reference rate of 7.46 krone to the euro for the foreseeable future. The Swedish krona, in contrast, is expected to fall from a rate of 8.81 krona to the euro in 1999 to a rate of 9.64 by 2003. Sterling gained against the euro from 1999 to the present, with its rate rising from 66 pence to the euro in 1999 and reaching a peak below 59 pence to the euro, but is expected to slip slightly from today's rate to 63 pence by 2003. Even in the light of these forecasts, however, the non-participating Member States of EMU enjoy a comparatively stable relationship with the euro as reflected by trends in the long-term interest rate (regarded as a predictor of long-term inflation).

Euro zone long term interest rates have not surprisingly converged to markedly lower rates over the last decade as a result of the efforts made to curb inflation in phase 2 of EMU and then monetary unification. The same is true of the non-participating Member States, however. In the Maastricht Treaty's own terms, this is evidence of a durable convergence between the non-participating Member States and the euro zone.

It was noted that "[national policy] convergence relates to performance and not necessarily the policies implemented by the Member States". The evidence presented points towards a marked and continued economic policy convergence in the EU and euro zone alike. In both the run-up to monetary union and over the forecast horizon, the economic policies of the Member States have conformed to the convergence criteria of price stability, fiscal sustainability and nominal exchange rate stability. Although recent economic events will require an adjustment in macroeconomic policies it is unlikely that this adjustment will jeopardize the objective of convergence in any real sense.

## 4. *RECOMMENDATIONS TO THE EUROPEAN PARLIAMENT*

### 4.1. **On the adjustment of procedures of the cycles monitoring macro-economic policies**

i) An amendment to the policy-making procedures leading to inclusion of a revision clause within the BEPGs should be foreseen, without, however, referring this task solely to the Ecofin Council.

ii) Member States should be encouraged by the EP to step up efforts to adapt national policy-making, implementation, and surveillance procedures to the European coordination framework. Despite progress in this respect in recent years, national parliaments in particular should pay greater attention to the BEPGs, in particular, and economic policy coordination generally.

iii) There is a further need to consider closer cooperation in fiscal and monetary policies in the euro zone.

### 4.2. **On the format of the BEPGs**

iv) The BEPGs 2002 should focus on a clear set of policy recommendations, because otherwise there is a danger of overload. In addition, since policy-makers at the national level tend to consider the country-specific recommendations without paying much attention to the introductory chapter, the BEPGs should be free from excessive duplication and unnecessary repetition.

v) One possible option could be a policy document formulating the broad and multi-annual economic policy direction of the European Union and its Member States, based on a proposal of the European Commission, with full participation by the European Parliament. The specific policy recommendations for each member state, the country-specific parts of the BEPGs, could become more precise, discussing the country's specific needs and in the light of the policy instruments available.

vi) With regard to the importance given to the consequences of the ageing population, especially on the pension and social security systems, it might be worthwhile to separate pensions from the chapter on Labour Markets. In addition, the theoretical and empirical links between unemployment, the social security system and the pension system are not as obvious as the current chapter implies.

vii) The exchange rate is an important part of the policy mix for *non-euro area countries* but it is not considered in the BEPGs. In consequence the guidelines have failed to address the contradiction between the internal and external balance of the economy, and its relationship to the value of the currencies outside the euro-area. This deficiency could be remedied by extending the BEPGs 2002 to include a discussion of exchange rate developments for the non-participating members of EMU, taking into account the potential effects of other policy recommendations on the exchange rate. By implication such an inclusion would increase the relevance of the BEPGs in the policy debates of the non-euro-zone Member States.

viii) Finally, although much progress has been made in countries which are substantially below the EU average with regard to economic development, the credibility of general policy recommendations would greatly benefit from doses of modesty and realism. The steady re-iteration of recommendations without real improvements is a dangerous political game both for the system's credibility and for the actors involved. The recommendations need to be further oriented to the medium and long-term targets set by the Lisbon European Council meeting.

### 4.3. On policy proposals

ix) Growth- and stability-oriented macro-economic policies in conjunction with comprehensive structural reforms at the member state level as well as at the EU level are crucial for a recovery of several Member States' economies. With uncertainty about the pace and timing of recovery from the current slowdown, Member States will have to keep a close watch on developments and be prepared to take fiscal action to complement monetary policy if signs of a worsening slowdown appear. If the slowdown proves, as is forecast, to be short-lived, the countries that have allowed their deficits to rise, especially Germany, will have to accelerate fiscal consolidation.

x) Even though times are difficult, necessary structural reforms should not be unduly delayed. Pension reforms remain particularly necessary in several Member States.

xi) Structural reforms in labour market policies are necessary in many Member States. They should continue tax and benefit reforms so as to remove financial disincentives to take up work and prevent early retirement. Generally, the member countries should be encouraged to intensify their efforts by developing preventive and employability-oriented strategies, especially to combat youth unemployment and long-term unemployment.

National targets for female participation in employment – as agreed in Lisbon – and gender mainstreaming strategies need to be established in all Member States.

xii) Implementing coherent life-long learning strategies should be a key task for the Member States in order not only to improving the employability but also to lay the grounds for employment growth and stronger entrepreneurship in the future. New technologies must play a central role in these strategies.

xiii) While progress has been made by reducing bureaucracy and administrative burdens, these efforts have to be continued on all levels to encourage further entrepreneurship. The Commission proposals for a simplification and improvement of the regulatory environment are thus to be welcomed and should lead to a coherent forward-looking approach of the European Union.

xiv) Member States should live up to their commitment to improve the efficiency and competitiveness of network industries providing services of general interest. It should be the aim of the institutions to achieve the full opening of the gas and electricity market by the year 2005 in the European Union, and to increase efforts in the integration of telecommunications and transport services.

xv) Efforts have to be intensified in the area of Research and Technology, both on the European and the member state level. In this respect, tax incentives can be part of such a strategy to increase private R&D investment, while Member States should set national targets for public R&D investment growth.

xvi) The European institutions as well as the Member States have to secure a timely implementation of the Financial Service Action Plan in order to ensure the continued stability and competitiveness of the EU financial sector and to promote growth and employment.

xvii) Member States should intensify efforts to set up and implement national sustainable development strategies, addressing employment, economic reforms, social and environmental policies in a mutually reinforcing way.

### 4.4. On the future role of the European Parliament in the European macro-economic coordination process

xviii) What is needed is a broad public debate on all aspects of European macro-economic policy making, involving all European and national actors, to establish an effective, balanced and democratically accountable policy mix for the European Union.

xix) In order to improve public awareness of European economic policy coordination, the involvement of the EP in this procedure should be strengthened.

xx) In order to have an impact on the economic policies of the Member States, the European Parliament should focus more on long-term analysis of the operation of the processes, rather than on issues of short-term economic management policy.

xxi) An annual debate bringing together representatives of the European Parliament and national parliaments of the member state on the implementation of the BEPG should be encouraged, or joint committee meetings of economic and monetary affairs committees of the European Parliament and the Member States. Such a debate should complement enhanced debates within national parliaments on the subject of the stability and convergence programmes. Closer cooperation could be sought within the framework of COSAC.

xxii) The Convention on the future of the European Union might deal with the relationship between the "classic Community method" and the "new open method of coordination". In this regard, the EP's delegation to the Convention should underline the urgent need for more democratic accountability throughout all EU's policy-making methods. Any policy-making method involving governments needs a clear-cut feedback to directly elected politicians; the Convention should be seen as a chance to establish a comprehensive set of rules to organise a more democratic and transparent kind of economic governance.

# PART I – MACRO-ECONOMIC POLICY-MAKING IN THE EC

## Chapter I – *THE NEW MODES OF GOVERNANCE IN ECONOMIC POLICY MAKING: A MINOR ROLE FOR THE EUROPEAN PARLIAMENT?*

During the last fifty years of European co-operation and integration Member States' governments as well as the EC/EU institutions have created, reformed and used a variety of instruments and procedures within a triangle between markets, governments and non-governmental networks as an arena for "the mediation of the interests of governments, administrations, supranational institutions and interest groups"[2]. New and/or revised sets of provisions offer European and national actors additional incentives and opportunity structures to solve their most serious socio-economic problems (see article 2 TEU, articles 2, 3, 4, 99, 125 TEC). Governments have created a complex set of rules that allow national and European actors both to participate in the EU policy cycle and to employ instruments that have an increasing impact on the domestic arena. However, in comparison with the conventional Community methods, the new modes of EU governance in economic policies, including the open method of coordination, offer little access and influence to the European Parliament.

EMU is not a single-rule exercise. It includes three sets of provisions resulting in three modes of governance: a "supranational" policy-making in monetary matters (art. 105 TEC), a "hard" coordination in fiscal policy (art. 104 TEC and the Stability and Growth Pact), and a "soft" coordination of employment policy (the Luxembourg process, art. 128 TEC) and of economic policy more generally (the BEPGs, art.99 TEC). Each of these provisions and their "institutional designs"[3] allocate different instruments to the EU level and enable access and participation for different groups of governmental as well as non-governmental domestic actors. These rules have been further developed in recent years at meetings of the European Council from Luxembourg in 1997, Lisbon in 2000 to Stockholm in Spring 2001. Governments have formed institutional and procedural channels for running their "business" more effectively.

In monetary policy, treaty provisions, the statutes of the European System of Central Banks (ESCB) and the ECB, as well as secondary legislation, including the rules of procedure of the ECB bodies, have laid down rules for a distinct institutional setting and policy-cycle style as patterns of behaviour which can be labelled as "supranational" policy-making. The ECB is solely responsible for decision-making in monetary policy. In principle, the ECB is constrained only by the treaty provision that its actions be pursued in order to maintain price stability (art. 105 TEC). In monetary policy, the ECB has the legal obligation to submit its annual report to the European Parliament (art. 113 (3) TEC), an obligation which has been voluntarily extended to quarterly reports. The annual report has to be presented by the President of the ECB with the EP using this opportunity to hold a general debate. The EP can also request hearings with members of the Executive Board including the president. It has become a practice that the EP Committee on Economic and Monetary Affairs conducts quarterly "monetary dialogues" with the ECB.

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[2] Peterson J., "Decision-making in the European Union: towards a framework for analysis", *Journal of European Public Policy*, 2:1, 1995, p. 69-93.

[3] Fligstein N. and McNichol J.A., "The institutional terrain of the European Union", Sandholtz W. and Stone Sweet A. (eds.), *European Integration and Supranational Governance*, Oxford University Press, New York, 1998, p. 59-91.

In fiscal policy, Member States have established distinct rules for a "hard" coordination in the procedures laid down in art. 104 TEC, completed by the fifth protocol to the Maastricht Treaty and further elaborated by the provisions of the Stability and Growth Pact of June 1997, to put into practice the excessive deficit procedure. These rules include supervisory roles on national budgets for the European Commission and the Economic and Financial Committee, leading to Council recommendations against a "sinner" state. "Hard" coordination in fiscal policy refers to the procedure enabling the Council to decide, voting by qualified majority, on considerable financial sanctions against a member state in case of a continuous breach of the provisions (art. 104 (11) TEC). The procedures assign no decisive role to other European institutions. The European Parliament is informed only afterwards and Member States cannot appeal to the European Court of Justice at a certain phase of the procedure. Nevertheless, the EP has repeatedly commented on the annual assessment of the implementation of stability and convergence programmes, which are submitted by the Member States as part of the surveillance procedures and assessed by the Council.

Also in the area of economic policy, the EP has a weak role. "Soft" coordination procedures have been introduced in art. 99 TEC with instruments such as monitoring policy processes and outcomes, providing general policy orientations, benchmarking, and the publication of "best practices". In contrast to the art. 128 TEC procedure on employment policy, art. 99 TEC on the BEPGs foresees a recommendation of the Council to a member state deviating from the principles laid down in the treaty. The Council can decide that these recommendations should be publicised, thus exposing the member state concerned to public debate on this issue (cf. the case of Ireland in February 2001). In addition to the art. 99 procedure, the Member States agreed in 1998 to enhance the deliberation and interaction process on economic policy by establishing the so-called "Cardiff Process" on structural reforms in the Member States. To complement the various processes on employment and economic policy coordination, they established in 1999 the so-called "Cologne process", constituting a Macro-Economic Dialogue at Community level between all relevant policy actors, including the social partners. Finally, a "social summit", with the participation of the EU-Presidency, a "troika" of EU governments, social partners and the European Commission, will now be held before each spring European Council meeting to develop and improve coordination of tripartite consultation on the various aspects of the Lisbon strategy. These coordination procedures can be labelled "soft" since the instruments have no direct legal impact for the Member States and do not include any sanction mechanisms as does the "hard" coordination of fiscal policy.

Member States have put the BEPGs (BEPG) at the centre of coordination. Thus the BEPGs are not only a simple monitoring mechanism for Member States' policies among others, but indeed the central policy tool for economic policy coordination encompassing the policy coordination mechanisms for fiscal, economic and employment policies. As the Helsinki European Council meeting put it, "the BEPGs provide the framework for the definition of overall policy objectives and orientations. The synergy between these Guidelines, the Employment Guidelines and the monitoring of structural reform should be further developed under the political guidance of the European Council"[4].

Against this background, the Member States have amended the procedures as laid down in the treaty provisions by reorganising the preparatory work prior to the adoption of the BEPGs and by giving certain tasks to the newly established annual spring meeting of the European Council. Since the year 2000, the Ecofin Council forwards the BEPGs to other relevant

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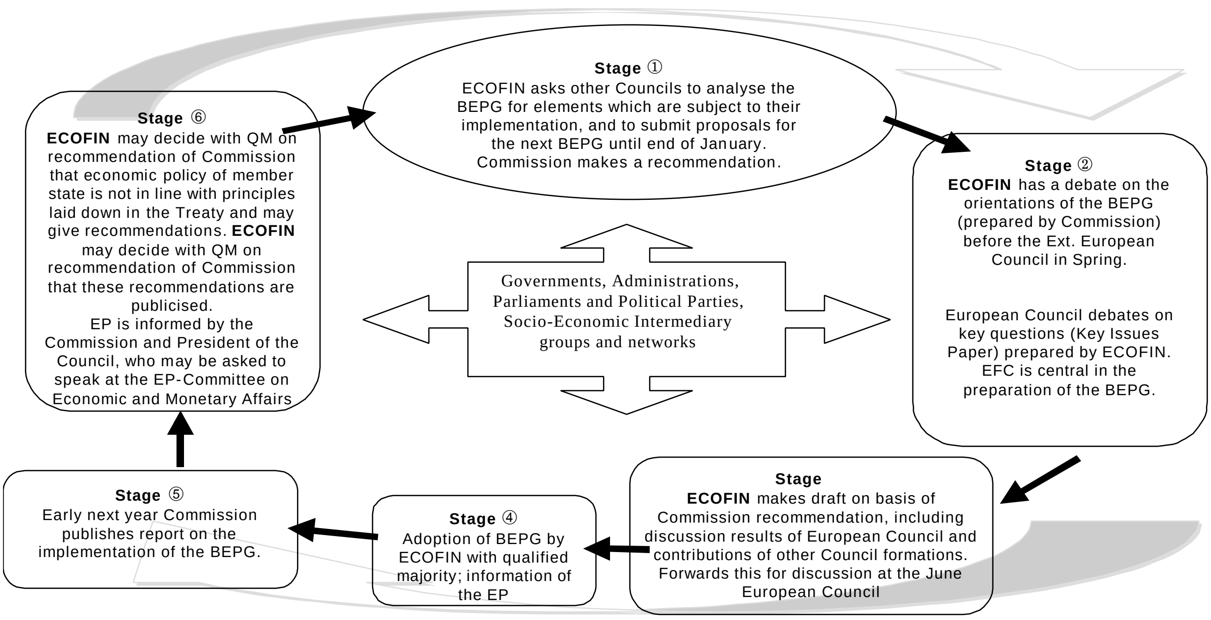
4 Helsinki European Council, *Presidency conclusions*, Brussels, 10 and 11 December 1999, indent 32.

Council formations to assume responsibility for implementation in their respective areas. These Council formations should also submit contributions by the end of January in view of the formulation of the forthcoming BEPGs. Based on the draft of the European Commission, which shall be explicitly based on the stability and convergence programmes, the Joint Employment Report and the Cardiff reports, as well as own assessments of the implementation of the BEPGs, the Ecofin Council holds an orientation debate at its meeting which precedes the annual spring meeting of the European Council, and drafts a key issues paper being then reviewed by the European Council. Afterwards, the Ecofin Council submits on a recommendation of the European Commission another draft to the June meeting of the European Council for discussion and endorsement. Only after this procedure will the Council adopt the BEPGs as provided for in the Treaty.

**Figure 1.1. The EU co-ordination of Economic policy (art. 99 TEC)**




In the "soft" coordination procedures of the economic policy-cycles, EU institutions other than the European Commission are involved to a limited extent. The European Parliament is granted "only" *ex ante* consultation and *ex post* information rights[5]. So far, the European Parliament has exercised these powers by commenting on the various policy documents produced within the policy-cycle, i.e. on the preparatory report to the Commission recommendation (state of the European economy), on the Commission recommendation itself, as well as in the wider context of macro-economic policy on the annual assessments of the stability and convergence programmes and, for example, on the annual spring European Councils. Furthermore, the EP Economic and Monetary Affairs Committee holds regular

[5] Art. 128 TEC on employment policy coordination foresees the *ex ante* consultation of the Economic and Social Committee and of the Committee of the Regions.

general meetings with the European Commission and the Council presidency during the year on the development of the economy and the BEPGs.

Also in the wider context of economic policy-making, the involvement of the European Parliament is distinctively different from other policy areas. The macro-economic dialogue explicitly excludes the participation of the EP. The currently promoted open method of coordination does not foresee a role for the European Parliament as it is focussed on the Member States with certain tasks allocated to the European Commission. Also the procedures for preparing the new annual spring European Council meeting, including the recently established "Social Summit", do not involve the European Parliament.

The role of the EP is thus reduced to observing and commenting on the process. As a consequence, the predominently intergovernmental procedures to make the multilateral surveillance process work have until now prohibited a broad European debate on the economic options as part of a deliberative democracy. A democratic opening-up of the policy-making procedures established to co-ordinate the macro-economic policies of the Member States should be envisaged.

## Chapter II – *THE IMPACT OF EUROPEAN ECONOMIC POLICY-MAKING ON THE NATIONAL LEVEL*

The central feature of soft policy-coordination is the non-binding character of the recommendations contained in the BEPGs. The BEPGs thus do not constitute a legal obligation on the Member States to implement the recommendations[6]. In order to be an effective element of (euro-zone) macro-economic policy coordination two features are of critical importance for the national level of this multi-level economic governance. The first and more general question refers to the attention paid to the BEPGs by national actors and the awareness of the policy recommendations. Second, with regard to budgetary policy, the timing and the procedures of decision-making on national level give some indication on how policy recommendations of the BEPGs have the chance to be incorporated in the governmental programme and budget for the succeeding budgetary year.

### 2.1. **Awareness of national policy actors**

#### 2.1.1. ***The Broad Economic Policy Guidelines***

The evidence suggests a growing awareness of the BEPGs amongst national actors in recent years. Such awareness has developed hand in glove with a growing appreciation of the interrelation between the various components of (euro-zone) economic policy and with the more vigorous approach taken by the European Union since medium-term economic goals were set at the Lisbon European Council. Several features of this awareness can be distinguished.

First and foremost, the **awareness and the public acknowledgement of the BEPGs by governmental policy-makers** is by far the most developed. Governments, and in particular, the relevant ministries for Finance and Economics are increasingly aware of the BEPGs and they now form a significant part of the context within which policy is developed. Some

[6] It has been noted, however, that art. 202 TEC stipulates a legal obligation of the Council to "ensure coordination of the general economic policies of the Member States". Cf. European Parliament Committee on Economic and Monetary Affairs, Report on the Commission's communication on strengthening economic policy coordination within the euro area, A5-0307/2001, Brussels, 14 September 2001, p. 13.

Member States have been more willing than others to adapt national policy-making, implementation, and surveillance procedures to the timing set by the European coordination procedure. This seems to go hand in hand with the attention paid by national policy-makers to the BEPGs. Two examples can be given.

a) In Germany, the BEPGs have been incorporated in the country's economic policy-making process. The Finance Ministry, which is the key-player in the implementation process of the BEPGs, relates all its policy-formulations (Annual Report, Monthly Report) explicitly to the BEPGs , even going so far as to adopt a similar structure[7]. The Ministry of Finance has set up an inter-ministerial committee that discusses and supervises the implementation of the BEPGs (the ministries involved are: Ministry of Finance, Ministry of Labour and Social Affairs, Ministry of Economics and Technology, Foreign Office, Ministry of Education and Research, and the Chancellery).

b) In Greece, official government positions, such as those contained in the National Economy and Finance Report on the 2002 Budget or those expressed by the Prime Minister and Ministers in Parliament, refer explicitly to the BEPGs. The Minister of Finance's General Report on the 2002 Budget – submitted to Parliament on October 2001 dwells extensively on the constraints arising for economic policy-making out of the BEPGs. The BEPG 2000 goals, mainly the effort to obtain full employment, to promote the information society, to keep social cohesion and to face the fiscal implications of population ageing have been frequently referred to in economic policy and general political statements.

There is also a growing tendency to refer explicitly to the specific policy recommendations included in the BEPGs both in the updated programmes of the Stability and Convergence Programmes and in the reports on economic reforms, i.e. the Cardiff reports.

Looking at the attention paid by **national parliaments** to the BEPGs as well as to **parliamentary procedures** to deal with the BEPGs and/or their implementation on national level, the picture indicates a much lower degree of convergence. Some national parliaments have more highly developed procedures than others, but a clear distinction has to be made with regard to the application of formal procedures and the effective use of these procedures. Furthermore, in most parliaments, the BEPGs are considered by specialised committees, either special European Committees, or by the relevant sector-specific committees. Again, some examples can be given.

In Germany, the implementation process is supervised by several parliamentary committees, i.e. the Finance-Committee, the EU-Committee and the Budget-Committee. Members of these committees however admit, that the BEPGs do not play a major role in the debates. There have been no detailed discussions in the parliamentary committees simply because the Committees did not ask for them. With respect to the plenary sessions of the *Bundestag*, there is no formal information procedure related to the BEPGs. Yet, there is a formal *ex ante* information procedure concerning the BEPGs prior to each Ecofin Council meeting at which the guidelines are scheduled for discussion. There has not been any specific debate on the BEPGs, however.

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[7] See also the first issue of the recently created Monthly Report of the Ministry of Finance with an article on the BEPGs and their impact on German economic policy making. Cf. Bundesministerium der Finanzen, "Die Grundzüge der Wirtschaftspolitik als zentrales Instrument der wirtschaftlichen Koordinierung in der EU", *Monatsbericht des BMF* no. 8, Berlin, 2001, p. 49-54.

In the UK, the scrutiny Committee of the House of Commons does consider the BEPGs in some detail, but the resulting Parliamentary report is largely a summary of the BEPGs and the UK Government's response to them[8]. Effective debate on the BEPGs in Parliament is limited by the confrontational style of Commons politics, Euroscepticism and the complex nature of the issues. The confrontational style of the Commons means that even Committee debates are used as an opportunity for the opposition to criticise government economic policy and for government MPs and the minister to argue its virtues. Euroscepticism is evident in the way the debates focus on the process rather than the guidelines. All these problems are manifest in the 2000 debate on the BEPGs[9].

In the Netherlands, the BEPGs are regularly forwarded to Parliament. They are explicitly referred to in parliamentary debates with the Minister of Finance prior to Ecofin meetings. It is interesting to note in this regard that such debates cover both policy developments in the Netherlands and, in a more general sense, in other parts of the EU. After initial scepticism about their importance, there is currently growing appreciation of the BEPGs, especially in the Standing Parliamentary Commission on Finance. They are considered to be most effective with respect to those issues which fall within the domain of Ecofin, because their objectives are more readily quantifiable. In other fields, such as structural adjustment, the absence of a clear yardstick makes assessment more difficult. One side-effect of the application of BEPGs is that the role of Ecofin has become more prominent compared to other Councils in the social and economic field. This is generally regarded as a positive development because of the fact that it effectively secures the promotion of sound economic policies.

Other countries, however, show a rather different picture. For example, in Austria, the BEPGs do not play any significant role in discussions in the Austrian Parliament. The topic was apparently on the agenda in the current legislative period only once when on the 21 March 2001 the grand committee of the National Council discussed preparations for the BEPGs 2001 within the context of a more general discussion about the European Council in Stockholm (22/23 March 2001). In the discussion itself, the BEPGs or closely related topics were not mentioned[10].

In some cases, the BEPGs have been subject to **party political debate**, either on specific recommendations or on the coordination procedure on the whole. For the latter, the Irish debate on the Council recommendation is the best example and is dealt with more extensively below. For party political debate in Sweden, opposition parties right of the centre, as well as the employer organisations, have stressed to the government that the guidelines should not be treated as an *à la carte menu* but rather implemented in full. The guideline on lowered level of taxation is a particular bone of contention in this regard. In France, the contents and general philosophy of the BEPG, especially with regard to macroeconomic and tax orientations, have been a subject of debate in the Parliament, as some components of the government's left-wing *majorité plurielle* consider their orientations too liberal.

In the UK, it is difficult to discern a debate specifically arising from the recommendations of the BEPGs. This is partly due to a lack of specificity in the recommendations, e.g. "keep the underlying position of government finances broadly unchanged", or because they accord with

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8 House of Commons, European Scrutiny Committee, *Broad Economic Policy Guidelines*, Nineteenth Report, London, 2000.

9 House of Commons, European Standing Committee B, *Broad Economic Policy Guidelines*, London, 2000.

10 Austrian Parliament, "Stenographische Protokolle des Nationalrates", no. IV-9 of annexes, Vienna, 21 March 2001.

widely accepted views of desirable economic policy measures, e.g. "increasing the supply of skilled ICT personnel". Where the content of the BEPGs has entered into debate is as an assessment of government economic policy. Thus the Government uses favourable comment as an endorsement, whereas the opposition uses unfavourable comments to criticise economic policy. In this way, the BEPGs are informing the political debate on the determination of national policy, although they are not seen as directly influencing that policy. For example, an extensive debate on the "golden rule" in Parliament has been largely carried out without considering its possible incompatibility with obligations under the BEPGs and the SGP. Even where discussions do occur in relation to the BEPGs[11] the impact on the policy-making process appears to be extremely limited. For example, in response to the Ecofin's opinion on the UK's Convergence Programme, the Economic Secretary to the Treasury (a junior government minister) stressed to the Parliament's Treasury Select Committee that the opinion was non-binding and that the government felt little obligation to respond to it[12].

At the same time, **public awareness** and **public discourse** to this new form of European governance seems to be much less developed. Political debate and public discourse remain remote from their real content, press coverage is almost non-existent – with the exception of the Irish case. In this respect, the attention given to the BEPGs by the media is strikingly different from the attention given to the Stability and Growth Pact. This divergence is obviously due to the legal obligations and the possibility of sanctions put down in article 104 TEC and compounded by Council Regulation no. 1467/97 and raises the question of an amendment of the provisions in art. 99 TEC. It furthermore seems to underline the European Parliament's contention that public awareness of European economic policy coordination can be substantially improved by strengthening the involvement of the EP in this procedure.

### 2.1.2. *The position of the European Parliament on the BEPG*

This study has paid particular attention to the awareness of national actors concerning the position of the European Parliament on the BEPGs in its resolutions. The available evidence is not encouraging[13]. In many Member States the resolutions do not play any significant role. While in Germany, the positions adopted by the EP are "carefully read" in the Ministry of Finance, systematically included in the briefing for the Minister, and, as such, "taken into account", there has not been any impact as of yet. In Greece too, positions of the EP on the BEPGs and -more generally speaking- the EP's positions overall in economic policy matters have not successfully penetrated either the political system's awareness of public discourse as carried out in the media (or, even, in academic discussion). The same can be said in the United Kingdom where the EP resolutions are not used by the Government to inform policy in this area. Some parliaments and relevant committees receive the positions adopted by the European Parliament, but evidence shows that they are dealt with neither in parliamentary debate nor even in committee structures.

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[11] House of Commons, Treasury Select Committee, Minutes of Evidence for Monday 2 May, The Council of Finance Ministers, Session 2000-2001, HC 459-i Committee, London, 2001.

[12] M. Johnson in: House of Commons, Treasury Select Committee, Minutes of Evidence for Monday 2 May, The Council of Finance Ministers, Session 2000-2001, HC 459-i Committee, London, 2001, p. 21.

[13] Cf. Wessels W., Maurer A. and Mittag J. (eds.), "Fifteen into One? The European Union and its Member States", Manchester University Press, Manchester, 2002 (forthcoming). See also, on national parliaments, Maurer A. and Wessels W. (eds.), "National Parliaments on their ways to Europe: Losers or Latecomers?", Nomos Verlagsgesellschaft, Baden-Baden, 2001.

This situation is not really surprising given the resolutions' inevitably rather general content and lack of country-specific comment. The role of the EP is seen by UK senior government officials as being most useful in long-term analysis of the operation of the processes, rather than in the short-term consideration of economic policy, which is thought to be legitimated through national parliament. This analysis seems to be shared by actors from other European countries and thus neatly reflects the overall current understanding of the European Parliament's role in the European economic co-ordination process, at least by governmental actors.

### 2.1.3. *The stability and convergence programmes*

The available evidence indicates that national actors are well aware of the stability and convergence programmes with differing degrees of penetration into the policy-making processes. In general the awareness for the stability and convergence programmes is much higher than for the BEPG. Some examples from Member States illustrate this assessment.

In fiscal policy-making in Germany, the stability and convergence programme is considered to be the defining element in the overall macroeconomic strategy and setting out of the time-horizon for the consolidation process. As one official puts it: "since its creation, the programme has become the centrepiece of our policy". Its definition and the updates define the broad guidelines applicable to all sectors of government. With respect to budgetary policy, however, the stability and convergence programme is of minor importance. The programme only refers to the broad fiscal policy stance. The distribution of costs and expenditures within the cabinet is not directly related to it. This explains, why the programme – as well as the BEPGs – is not a topic of major debates in the parliamentary committees. It defines the overall negotiation space in which the political manoeuvres on distribution-related issues take place.

In Austria, the updated stability programmes and the related Ecofin Council opinions are regularly discussed by the budget committee of the National Council. Especially in the last two years the stability programmes and the Ecofin Council opinions have been included in the national political debate about the governments fiscal policy. The critique of the Ecofin Council concerning Austria's fiscal policy in May 2000 was a welcome argument for the new government with which to accuse the former government of an irresponsible budget policy. The positive opinion of the Ecofin Council concerning the second update of the stability programme in February 2001 was again a welcome argument for the government in the political debate. Another reason for the higher awareness of the stability programmes was the negotiations between the government, the *Bundesländer* and the municipalities about an intra-Austrian stability pact in order to lay down the contributions of the territorial authorities to the achievement of the "zero-deficit".

In Sweden, the programmes are discussed in the Standing Committee on Finance and the EU Advisory Committee before they are discussed in the Council. In 2001, the proposed recommendation to Ireland for not following the economic guidelines was discussed in the EU Advisory committee, where opinions differed[14]. The procedure with convergence programmes is taken very seriously by the Swedish government and the stability of public finances is considered to be very important.

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[14] Some parties argued that the recommendation was a challenge of national sovereignty and should be resisted. However, the government supported the recommendation to Ireland and considered the content of it uncontroversial. It was considered to be in Sweden's national interest that inflation is avoided in other Member States and the EU area at large.

In the United Kingdom, the Convergence Programme has become an integral part of the UK budgetary cycle. The assessment by Ecofin/Council is regarded as an important but non-binding assessment of the UK's economic strategy. The convergence programmes are not subject to significant consideration in Parliament. This is because they consist largely of government measures that have already been announced. For example, discussion of the UK's budgetary position takes place in relation to the budget, not in relation to the convergence programme. Ecofin/Council opinions on the UK convergence programme would only be subject to significant debate in the aftermath of an adverse recommendation.

The impact of the Ecofin Council opinions depends on their nature. Some opinions are policy-related, some contain formal requirements. Legal and formal decisions taken by the Ecofin Council have a very strong impact as they include elements such as the recent new version of the "Code of Conduct", which defines the legal framework for the stability and convergence programmes, along with their statistical requirements. The impact of non-formal opinions seem to be quite weak. These opinions are sometimes considered during the drafting process. Yet, as government officials have explained, most statements by Ecofin are very broad and political and thus have little impact on the stability and convergence programme.

With regard to the involvement of national parliaments in the establishment of national stability or convergence programme, so far no national parliament has formally endorsed the document before it has been transferred to the European level. During the update of the programmes at the end of the year 2000, the governments of France and Sweden submitted the programme to the national parliament before it was submitted to the EU and it was only in France that the government actually presented the programme in parliament with a debate following this presentation. While in Ireland the parliament and in Luxembourg the relevant parliamentary committee can discuss the programme, the Dutch parliament can also vote on a resolution. In all other countries, no similar procedures exist or are in operation[15]. Nevertheless, as the stability and convergence programmes usually do not constitute a completely new governmental programme but indeed refer to the national budgets, indirect parliamentary endorsement is given by the vote during the budgetary procedure.

There is, however, a trade-off between the tight synchronisation of annual budgetary procedures and the submission of the stability or convergence programme[16], which is also relevant to the more important question of the impact of the Ecofin opinion on national fiscal policy. If, as it has been the case during the last three rounds of the surveillance procedure, national budgetary processes have been concluded by the time of the endorsement of the opinion in Ecofin, possible more principle European recommendations or even concerns cannot be taken into consideration before the next budgetary procedure. Recommendations dealing with the next year's budget are moreover based on current forecasts and assumptions which might very easily change during the course of the year. If a further strengthening of the fiscal policy procedure is desired, the timing of the European co-ordination procedure should then be adapted so that Member States' governments submit their stability or convergence programme at the beginning of the annual budgetary procedure on the national level, thus enabling parliaments to take into account the opinion of Ecofin when adopting the budget.

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15 Cf. European Commission, "Public Finances in EMU 2001", *European Economy*, No 3, 2001, p. 44.

16 The United Kingdom is an exception as its budget does not run on a calendar year basis as are those countries which have adopted medium-term frameworks to which annual budgets have to comply.

### 2.1.4. *The position of the European Parliament on the stability and convergence programmes*

Resolutions by the EP are read and analysed by civil servants in the relevant ministries. The resolutions are (in most but not all cases) forwarded to the members of national parliaments and to the relevant national parliamentary committees involved in the economic policy-making process. They are discussed neither in these committees, however, nor in parliament. Furthermore, the absence of interest from the press was noted in most Member States. The European Parliament's resolutions are not considered to have any discernable impact on government policy. Even favourable positions of the EP, such as the support of the golden rule in the United Kingdom[17], are not referred to by governments.

In general, they are considered to be too long and not precise enough. Officials state that the MEPs "apparently lack precise knowledge of the issues". The format of EP resolutions is said to be ineffective: introductory statements are too long; precise recommendations, demands or criticisms are not formulated concretely but hidden in imprecise policy-statements. EP resolutions could have a much stronger impact if they became more target-oriented.

## 2.2. **Functioning of economic policy making**

### 2.2.1. *The coherence of the BEPGs with the general orientation of Member States' economic policies*

Comparing the overall *general* orientation of Member States' economic policy and the approach taken in the BEPGs, a broad coherence can be observed. In some respects, the general recommendations "state the obvious" and are thus an example of "form follows function" dynamics. They contain topics "that are on the agenda anyhow". The general direction of the guidelines and recommendations is usually supported by governments, a fact which is hardly surprising given the procedures leading to the adoption of the BEPGs and the role assigned to national civil servants during the preparatory phase.

The BEPGs are recognised as containing an assessment of performance as well as offering new perspectives on policy direction. They thus inform the policy debate and certainly add value. Moreover, the BEPGs are conducive to improvements in economic policy in other EU Member States, thus generating a positive spill-over to all EU members at large, but without imposing a single "model" of policy-making.

With regard to the form of the Council recommendations it was noted that there are many repetitions. Some of the general recommendations are also considered to be quite "ambitious". With respect to the country-specific recommendations, however, governmental officials in Member States note the Commission's "impressive self-confident determination in formulating precise policy requirements". They agreed that the country-specific recommendations do not necessarily state the obvious and that the demands formulated by the Commission are considered to be less surprising than they are demanding. The Commission is said to succeed in pushing through recommendations that it considers to be of major importance, especially at the time when country-specific recommendations are drafted.

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[17] European Parliament, Committee on Economic and Monetary Affairs, "Report on the annual assessment of the implementation of stability and convergence programmes 2001", A5-0127/2001, Brussels/Strasbourg, 2001, point 4, p. 7.

This overall assessment does not rule out cases in which Member States do not strictly follow recommendations included in the BEPGs, be they general or country-specific. In cases of potential misalignment between the recommendations and Member States' policies, the recommendations range from being a matter of political debate to a simple utterance to be safely ignored. Most notably in budgetary policy, but also in the other policy fields, national political choices sometimes lead to a different prioritisation of various objectives, as the BEPGs are considered precisely as guidelines and recommendations and hence not as binding in character. A distinct divergence between the medium and long-term targets agreed upon on European level and current Member States' policies is not apparent, however.

Some examples can be cited, with Ireland being the most notable one. It was the first country to be criticised by the Ecofin Council, based on art. 99 (4) TEC because Irish budgetary policy was adjudged to be inconsistent with the BEPGs 2000. In the recommendation the Ecofin Council noted that the Irish budget for 2001 is expansionary and pro-cyclical and therefore inconsistent with the guideline to ensure economic stability. In some cases, the timing of reforms is discussed. The government in Sweden, for example, may agree with the content of a recommendation but may not consider it to be an appropriate time to implement such reform[18]. Differences concerning the speed and the methods of implementing the recommendations have also come to the fore on occasion in Austria. This stems primarily from the difficulties of implementing certain policy goals in a given political landscape with established structures, different actors and vested interests. Some recommendations are not in line with the ideas of the government and are therefore ignored. This is the case with the recommendation of the BEPGs 2001 to continue reforms in the pension system. Since reforms of the pension system usually lead to emotive public debates, the government is reluctant to air this topic prior to the 2003 general elections[19]. Whether the mounting pressure in the context of the open method of coordination in the field of pensions will change this position of the government remains to be seen.

A case which is less an issue of non-compliance than one of philosophical opposition, is the medium-term plan for fiscal policy in the United Kingdom. The problem here arises because the Code for Fiscal Stability permits the UK government to run a budget deficit over the medium term (providing that it is for the sake of public investment), thus contravening the terms of the Stability and Growth Pact. While arguments in favour of the Stability and Growth Pact are well rehearsed in the literature, the Code for Fiscal Stability has also received high praise. The Code represents a marked improvement in fiscal policy-making in the UK. Kell[20] finds such rules to be well-formed, transparent and enforceable and judges that the Fiscal Code of Conduct conforms in several important aspects to the ideal fiscal rules as advocated, for example, by Kopits and Symansky[21]. From this perspective, the BEPG's criticisms of UK fiscal policy can be seen less as an appeal to virtuous economic behaviour and more as a defence of one economic doctrine against another. Indeed, this point was borne out in recent debates

[18] Cf. Junestav M., "Labour Cost Reduction, Taxation and Employment. The Swedish Case" Draft Paper prepared for the SALTSA Workshop "The Transposition of European "Soft" Social Policy Measures at National Level", Brussels, 2001.

[19] See the comments made by the Austrian permanent secretary for finance on the occasion of the Ecofin meeting in May 2001, cf. *Der Standard*, 8 May 2001.

[20] Kell M.S., "An Assessment of Fiscal Rules in the United Kingdom", International Monetary Fund, *Working Paper* no. 01/91, Washington, 2001.

[21] Kopits G.F. and Symansky S., "Fiscal Policy Rules", International Monetary Fund, *Occasional Paper* no. 162, Washington, 1998.

surrounding the future of the Stability and Growth Pact in which the merits of expenditure targets (similar to those of the UK) over the existing deficit targets were openly discussed. As a consequence it should be recognised that any further criticisms of UK fiscal policy within the BEPGs could well intensify this debate still further.

### 2.2.2. *Assessment of the Commission's implementation report for the year 2000*

Assessing the Commission's implementation report for the year 2000 the study in general considers it as adequately reflecting the implementation of the BEPGs by the Member States. The Commission's implementation report is said to have provided a useful and accurate appraisal of the implementation of the BEPGs 2000. In the UK, senior government officials described the report as a valuable and hitherto absent form of feed-back on the BEPGs implementation. Some national actors, however, although they are in agreement with most of the report, objected to some judgements of the Commission. In Germany, for example, the criticism of the pension reform was considered to be too harsh, insufficiently justified and, above all, "rather imprecise".

Furthermore, is has been noted that in some areas the Commission's implementation report seems to accept fairly vague measures as being sufficient whereas in other areas concrete actions have been deemed insufficient. In Austria, for example, the Commission considered the recommendation to replace one-off measures to consolidate public finances by permanent measures as having been adequately addressed by an announcement that the budget would be balanced by 2002. However, the Commission itself criticises the fact that such balance will be reached through increases in the already high tax burden. Other measures taken by the Austrian government have been deemed to be insufficient, however. Examples include the pension reform and the liberalisation of the energy markets. As the pension reform, which is designed to raise the retirement age, took effect only on 1 October 2000, it is thus rather early to evaluate the effects of this reform. Nevertheless, the Commission regards the reform as insufficient and predicts increasing spending pressures in the public pension system[22]. In the area of energy markets the Austrian parliament adopted an "Energy Liberalisation Act" in the summer of 2000 that will fully liberalise the electricity and gas markets by 2001 and 2002 respectively. Although this more than covers the EU directives on the liberalisation of the energy markets, the Commission was not satisfied and continued to criticise "rigidities and high prices"[23].

### 2.2.3. *Institutional adaptations on member state level*

The co-ordination procedures of macro-economic policy-making not only affect policy choices of national actors, but are also related to institutional adaptations on member state levels. While the non-binding character of the art. 99 TEC procedure on the BEPGs does not necessitate institutional changes on the domestic levels, the Treaty provisions on budgetary discipline explicitly refer to national policy-making procedures. Within the framework of the excessive deficit procedure, which fills out art. 104 TEC in regard to the hard coordination in fiscal policy, Member States have committed themselves to ensure that domestic budgetary

[22] This assessment is shared by the IMF, that also expects continued pressure to reform the pension system. Cf. International Monetary Fund, *Public Information Note on the conclusion of Article IV consultation with Austria*, Washington, 2001.

[23] European Commission, *Report on the Implementation of the 2000 Broad Economic Policy Guidelines*, ECFIN/176/01-EN, Brussels, 2001, p. 115.

procedures will enable them to fulfil the treaty requirements[24]. It is in this area that institutional adaptations have taken place or are in the process of being implemented. Two features can be distinguished[25].

With the medium-term targets set by the Stability and Growth Pact, mechanisms are necessary to amend domestic procedures which are oriented towards annual budget cycles. A number of members states have therefore established expenditure control mechanisms or medium-term budget planning procedures, albeit with different degrees of enforcement mechanisms. Multi-annual budgeting frameworks have been established by six countries (i.e. Ireland, Italy, the Netherlands, Finland, Sweden and the UK). They vary with regard to the introduction of expenditure ceilings either for the central government as a whole or for departmental expenditure envelopes, as well as with regard to the binding character of these expenditure ceilings. In some cases, these expenditure ceilings are generally formulated as an objective (e.g. in the case of Italy), while in other cases explicit mechanisms will be enforced in case of expenditure overruns. In other countries, spending targets are set without being explicitly incorporated into multi-annual budgeting systems. In addition, these mechanisms are in various countries complemented by rules on how to deal with growth dividends on the revenue side. Finally, some countries complement expenditure control frameworks with numerical budgetary rules.

A second feature refers to the contribution of the various levels of government to the general government balance under the Stability and Growth Pact (SGP). As the central government is the level of government responsible vis-à-vis the European level, budgetary developments on the regional and local level may have a decisive impact on aggregate budgetary balance. The ""financial significance" of sub-national government in the SGP context depends upon the part of total general government expenditure they account for, and the existence of independent powers of borrowing and the possibility to claim transfers from the central government to cover financial shortfalls"[26]. In this context, the percentage of sub-national government expenditure differs substantially between the Member States, being relatively high in Germany, Spain, Sweden, Finland and Denmark and relatively low in Ireland, the Netherlands and Portugal. Also in Belgium, local government enjoys a relatively high level of financial autonomy.

While respecting the autonomy of local and regional governments, Member States have to varying degree established procedures to increase central government power over sub-national finances. These include borrowing limitations for sub-national governments or a direct balanced-budget constraint (as in the case of Sweden), or co-ordination procedures between different levels of government. These can take the form of – usually legally non-binding – agreements established in appropriate bodies (such as the Finance Planning Council in Germany or the Fiscal and Financial Council in Spain) or national stability pacts (as is the case in Austria).

As this overview demonstrates, European co-ordination procedures present serious problems of adaptation on the domestic level and, depending on national differences, Member States are continuing to introduce institutional arrangements which should contribute to a better implementation of both the BEPGs and the Stability and Growth Pact.

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[24] Art. 3 of the protocol on the excessive deficit procedure of the TEC.

[25] Cf for the following, European Commission, "Public Finances in EMU 2001", *European Economy,* No 3, 2001, p. 38ff.

[26] ibid., p. 45.

Chapter III – *CONCLUSIONS*

With regard to the procedures of European economic-policy making as well as the role of the European Parliament, some conclusions can be drawn. They concern both the European level as well as the national level of decision-making.

(1) Further reforms of the existing procedures should be considered if the European Union wants to achieve the goals set in Lisbon. Some progress has been made in recent years. Policy learning – as opposed to adopting one single model – as well as the necessities stemming from the start of stage three of EMU have led to a number of improvements in economic-policy coordination. Apart from the widening of scope of policies addressed by European coordination (e.g. the Cardiff process on structural reforms, but also other policy spill-overs from EMU), the strengthening of the horizontal links between various Council formations in their preparation of the input into the BEPGs, can be seen as a major improvement. Furthermore it has led to additional adaptations, including the European Commission's preparatory work for the BEPGs.

While these efforts aim at making the procedures more coherent and effective, more has to be done in order to enable European actors to base their assessments and policy choices on sound and comparable statistical data. The "code of conduct" and setting-up of the "Lisbon" list of indicators (agreed between the Commission and the Council and approved by the European Council in late 2000) are initial steps taken in this respect[27].

(2) In order to make the policy instrument of the Broad Economic Guidelines more effective, a revision of its structure and content should be considered. First, it should again be stressed that the general policy recommendations are often stating the obvious and thus have little direct impact on the Member States' macro-economic policies. It could be argued that many of these recommendations are also covered by the conclusions of European Council meetings which lay the foundation of the macro-economic policy-stance of the Union- by the governments of the Member States. Second, the BEPGs need to be relieved from too many duplications and repetitions. Policy-makers on the national level tend to consider solely the country-specific recommendations without paying much attention to the introductory chapter.

One possible option could be a policy document formulating the broad economic policy direction of the European Union and its Member States, which however necessitates a treaty revision. This document should be adopted not on the basis of the art. 99 TEC procedure, but based on a proposal of the European Commission and with full participation of the European Parliament. Given the general character of such an economic strategy, it could well be adopted as a multi-annual programme. This procedure will add to the awareness given to European economic policy coordination and might lead to the necessary public discourse on the key economic options available.

Nevertheless, the introduction of such a general policy document should preferably not be accompanied by provisions that are legally more binding for the Member States, both for euro zone Member States as well as for the European Union as a whole. The introduction of possible sanctions if Member States do not adhere to policy recommendations in the BEPG or in the Ecofin opinions on the stability and convergence programmes – provided art. 104 TEC and the Stability and Growth Pact is fully respected – is at present not advisable, as it might

[27] The European Commission had to acknowledge that, by presenting the report on the implementation of the 2000 Broad Economic Policy Guidelines, it was not able to give "a conclusive judgment about the degree of implementation" based on the available data.

lead to the adoption of a "one model fits all" approach without taking into account national diversity.

(3) With regard to the specific policy recommendations for each member state, the country-specific parts could become more precise, discussing the specific needs and possible instruments of a country in a more detailed way. However, the BEPGs 2002 should not present too many policy recommendations, because there is a danger of overload. It could furthermore be helpful if the Council tries to merge the BEPGs and the opinions on the stability and convergence programmes. Given the timing of the publication of the opinions, in most cases (i.e. for countries with budgetary cycles starting on 1 January) these opinion cannot be taken into account by the Member States' budgetary procedures anyway. However, the Commission and the Council clearly have to tread carefully, because Member States have already shown that they take a dim view of advice which they feel is either unjustified or based on questionable economic analysis, Ireland in 2001 being a case in point.

(4) The timetable for the Guidelines does not seem to maximise their effect on the economic policies of the Member States, especially when the economic situation changes and the guidelines remain focused on economic forecasts run for the entire year[28]. As can be seen during the period of the BEPGs for 2001, economic developments – which are determined also by factors outside the sphere of influence of the political and economic actors within the European Union – can therefore change the basis of the recommendations agreed upon in the BEPGs. An amendment to the policy-making procedures leading to the BEPGs to include a revision clause should be foreseen, without, however, referring this task solely to the Ecofin Council.

(5) There is the basic understanding that not only does the European policy-cycle with the BEPGs at its centre need to be adjusted, but moreover that proposals should be made towards reconciling national policy cycles with the European timetable. Recommendations on national reports could in this regard be transposed at a more appropriate time into national programmes. Adaptation processes on the national level should thus lead to a greater convergence of national policy formulation and policy-making and should further coordinate national policies with European timetables. This could lead in turn to increased efforts by actors in national and European institutions to combine the various instruments of economic and social policies in order with the aim of producing a successful "policy mix" that would be in line with the treaty objectives (arts 2, 4, and 105.1 TEC).

(6) In the EMU macroeconomic system, which combines EU-level decision-making on monetary policy by the ECB with national decision-making on fiscal policy, the arguments for rules constraining fiscal autonomy are persuasive. The SGP and the BEPG are the chosen instruments for this purpose, but it should be recognised that there is a degree of arbitrariness in the target values for the deficit and debt, and that differently configured rules might be equally or more effective. It has been suggested, for example, that the UK approach, which includes a symmetrical inflation target in relation to monetary policy and the so-called golden rule for fiscal policy (allowing deficits to increase if there is a corresponding public investment, as opposed to spending on public consumption), offers a more attractive policy mix. It can also be argued that rules which are not properly respected will not be effective, so that implemented matters, as well as the way rules are framed.

[28] See also European Parliament Committee on Economic and Monetary Affairs, "Report on the Commission's recommendation for the broad guidelines of the economic policies of the Member States and the Community in 2001", A5-0165/2001, Brussels, 2 May 2001, p. 10.

(7) At the same time, the channels provided in the new coordination procedures for domestic actors should be broadened as they are currently too few in number to offer a credible alternative to domestic opportunities in national policy-making structures. This is in particular true for the national parliaments as they are the central actors in national budgetary procedures and, above all, important contributors to public discourse in the Member States. Initial proposals have been made in this respect calling, for example, for an annual debate on the assessment of the implementation of the BEPGs between the European Parliament and the national parliaments of the euro area along with corresponding debates within national parliaments on the updated stability programmes of their governments[29]. It would also be useful to focus on the BEPGs in sessions of the COSAC[30] or joint committee meetings of economic and monetary affairs committees of the European Parliament and the Member States.

(8) This does, above all, include a strengthening of the European Parliament in order to promote a broad European debate on the economic options as part of a deliberative democracy. A democratic opening-up of the policy-making procedures established to co-ordinate economic policies of the Member States should be envisaged.

[29] Cf. the resolution of the European Parliament, "The Commission communication on strengthening economic policy coordination within the euro area (COM(2001) 82 - C5-0173/2001 - 2001/2083(COS))", adopted in plenary on the 4th of October 2001

[30] This could be done either by setting up a COSAC-related permanent working group of MEPs and MPs, or by granting the COSAC's agendas at least one session to deal with EMU and economic policy-making.

# PART II – IMPLEMENTATION OF THE BROAD ECONOMIC POLICY GUIDELINES AND THE STABILITY AND CONVERGENCE PROGRAMMES

## Chapter IV – *GENERAL IMPLEMENTATION ANALYSIS IN CROSS-NATIONAL PERSPECTIVE*

The following chapter provides a cross-national perspective on the implementation of the BEPGs of 2001 as well as the stability and convergence programme updates for 2000/2001. The BEPGs for the year 2000 are taken into account where relevant, but a detailed overview of the recommendations of the year 2000 is not provided, given the implementation report of the European Commission as well as the nature of the BEPG in general, i.e. the consecutive updating of the BEPG ensures that developments of the preceding year are taken into account when establishing the BEPG for the current year[31].

The chapter follows the structure of the general recommendations of the BEPG 2001 and looks both at the general orientation of the guidelines as well as the implementation record of the Member States.

### 4.1. **Growth- and stability-oriented macroeconomic policies and the quality and sustainability of public finances**

The key challenges for the Member States and the EU as a whole did not change significantly during the year 2001, although it can be argued that the deterioration in global economic conditions reinforced the pressures on economic policy. In the light of the global economic downturn in the year 2001 and the uncertainty about the timing and speed of recovery, the internal growth dynamics have become more important. Growth- and stability-oriented macro-economic policies in conjunction with comprehensive structural reforms at the member state level as well as at the EU-level are crucial for a recovery of several Member States' economies. In this respect, the economic performance of several Member States in 2001 has been below the expectations set out in the 2001 BEPGs. These were written at a time when the extent of the global economic downturn was not yet visible, as a result of which they were overly optimistic. While the events of 11 September clearly accentuated the global economic deterioration, it is important to stress that they do not fully account for the downturn in the EU economy since the spring of last year, nor its marked impact on a number of Member States. With hindsight, it is clear that Germany, in particular, was already on the brink of recession by the summer of 2001. As the OECD notes, the attacks "aggravated this deterioration by eroding confidence"[32], and it is clear that the this had a dampening effect on economic activity.

Nevertheless, many indicators of economic activity suggest that the worst is now over, even if it is likely that some measures – notably unemployment – will continue to paint a sombre picture in the first half of 2002. An analysis just released by UBS Warburg states that "our

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[31] As stated in subparagraph 2.2.2., the implementation report of the European Commission of the BEPGs 2000 (European Commission, Report on the implementation of the 2000 Broad Economic Policy Guidelines, ECFIN/176/01-EN, Brussels, 07.03.2001) is considered as an adequate overview of the developments of the macro-economic policies of the Member States in this year, both by national actors and by the authors of this study.

[32] OECD, *OECD Economic Outlook*, No. 70, December 2001, p. 3ff.

own leading indicator suggests that co-incident indicators of confidence in the industrial sector should, broadly, continue to rise over the coming months, implying that the recovery will take hold quite quickly."

It has to be recognised that the European economy cannot be expected to be immune from global economic developments, and that the downturn affected export growth which, in turn, led to a cut in business investment. It also became apparent mid-way through 2001 that domestic demand in the Euro-zone was not as strong as expected. As the European Commission Autumn Forecasts points out, "structural reform has not gone far enough to enhance in a sufficient way the euro area economy's resilience to exogenous shocks. The terms-of-trade shock was reflected in rising unit labour costs, not because of wage increases, that remained moderate, but because productivity developments were lagging behind"[33]. However, the fall-off in demand was clearly also important, and it would appear that the Commission spring forecasts under-estimated its effects.

**Table 4.1.1. GDP Growth (per cent per annum)**

| | Commission | | | | new SCPs | |
|---|---|---|---|---|---|---|
| | 1999 | 2000 | 2001 | 2002 | 2001 | 2002 |
| **Belgium** | 3.0 | 4.0 | 1.3 | 1.3 | 1.1 | 1.3 |
| **Denmark** | 2.1 | 3.2 | 1.3 | 1.6 | | |
| **Germany** | 1.9 | 3.0 | 0.7 | 0.7 | 0.75 | 1.25 |
| **Greece** | 3.4 | 4.3 | 4.1 | 3.5 | 4.1 | 3.8 |
| **Spain** | 4.1 | 4.1 | 2.7 | 2.0 | 3.0 | 2.4 |
| **France** | 2.9 | 3.1 | 2.0 | 1.5 | 2.3 | 2.5 |
| **Ireland** | 10.9 | 11.5 | 6.5 | 3.3 | 6.8 | 3.9 |
| **Italy** | 1.6 | 2.9 | 1.8 | 1.3 | 2.0 | 2.3 |
| **Luxembourg** | 5.7 | 9.5 | 4.0 | 3.0 | 3.9 | 5.3 |
| **Netherlands** | 3.7 | 3.5 | 1.5 | 1.5 | 2.0 | 2.0 |
| **Austria** | 2.8 | 3.0 | 1.1 | 1.2 | 1.3 | 1.3 |
| **Portugal** | 3.4 | 3.4 | 1.7 | 1.5 | 2.0 | 1.75 |
| **Finland** | 4.0 | 5.7 | 0.5 | 1.7 | 0.6 | 1.6 |
| **Sweden** | 4.5 | 3.6 | 1.4 | 1.6 | 1.7 | 2.4 |
| **UK** | 2.1 | 2.9 | 2.3 | 1.7 | 2.25 | 2 – 2.5 |
| **Euro Area** | 2.7 | 3.4 | 1.6 | 1.3 | | |
| **European Union** | 2.6 | 3.3 | 1.7 | 1.4 | | |

*Data for 1999 and 2000: Eurostat, structural indicators, last update: 11.01.2002*
*European Commission, Autumn 2001 Forecasts for 2001-2002, European Economy, Supplement A, Economic Trends, No 10/11 - October November 2001.*
*Denmark has not yet submitted its convergence programme update.*

The 2001 BEPGs start with the rather obvious, though ultimately not very meaningful recommendation that the macro-economic policies of the Member States should be orientated towards sustaining growth and employment and preserving price stability. The text goes on to call on the Member States to aim for a balanced economic expansion and to try to realise their growth potential. The advice also stresses the importance of fiscal policies geared to the

[33] European Commission, "Autumn 2001 Forecasts for 2001-2002", *European Economy*, Supplement A, Economic Trends, No 10/11, October/November 2001, p. 8.

achievement of budgetary positions close to balance or in surplus and of careful monitoring to ensure that there is no slippage from the stability programme targets.

Member States were also counselled to prepare budgets for 2002 which continue to assure fiscal positions close to balance or in surplus and at the same time to avoid pro-cyclical fiscal policies. Those Member States most at risk from inflationary pressures and overheating were advised to tighten budgetary policy, to pursue wage moderation and to advance structural reforms aimed at an appropriate macroeconomic policy mix. These recommendations are consistent with the ambitions of the SGP and represent what might be termed "the Brussels consensus" about how macroeconomic policy in the euro-zone should be conducted.

It is, therefore, instructive to look at what has happened and it is apparent that recent fiscal policy developments and prospects present a mixed picture. On the one hand, the collective budget deficit of the euro area has continued to shrink, falling to 0.8% of GDP in 2000 (net of UMTS revenues), a drop of 0.5% of GDP compared with 1999, and at the same time the tax burden is being lowered in most countries. Moreover, most of the one-off budgetary receipts from the sale of UMTS licences have, as agreed, been used to reduce debt.

On the other hand, there is evidence that public finances in the European Union deteriorated in the year 2001. The average general government balance in the EU, net of UMTS-proceeds, is projected to have been -0.5% of GDP in 2001, but this reflects somewhat better figures for the three "outs" than the twelve "ins". For the euro area, the Commission projects an overall deficit of – 1.1% of GDP in 2001 so that the overall public finances worsened for the first time since 1993. The targets of the Member States as documented in the 2nd stability or convergence programme updates will therefore be missed by 0.5% of GDP for the euro zone and by 0.3% for the EU as a whole. Given the slowdown and the operation of automatic stabilisers, these cannot really be seen as particularly worrying figures, although they do break the trend toward fiscal consolidation that has characterised the period since 1993.

A recent analysis by the Commission confirms that the deterioration in public finances is largely attributable to the operation of automatic stabilisers in a macroeconomic environment that is significantly less favourable than expected in the above-mentioned stability programmes and envisaged at the time the BEPGs were agreed. The Commission analysis also suggests that the cyclically-adjusted budget balances of the euro are set to deteriorate slightly in 2001. The silver lining in the recent economic downturn is that pressures on wage inflation have, on the whole, diminished as the ability of wage negotiators to secure pay increases well above the rate of inflation will be curtailed. This will allow those Member States with relatively tight labour markets more easily to contain inflation, with a further impetus coming from the fall-off in oil prices.

**Table 4.1.2 General Government Fiscal Balance**
(per cent of GDP, excl. UMTS revenues): comparison between SCP 2000 and Commission forecast

| | SCP 2000 | | Commission | | Difference | |
|---|---|---|---|---|---|---|
| | (a) 2001 | (b) 2002 | (c) 2001 | (d) 2002 | (a)-(c) | (b)-(d) |
| **Belgium** | 0.2 | 0.3 | -0.2 | -0.2 | -0.4 | -0.5 |
| **Denmark** | 2.8 | 2.6 | 2.0 | 1.6 | -0.8 | -1.0 |
| **Germany*** | -1.5 | -1.0 | -2.5 | -2.7 | -1.0 | -1.7 |
| **Greece** | 0.5 | 1.5 | -0.4 | 0.3 | -0.9 | -1.2 |
| **Spain** | 0.0 | 0.2 | 0.1 | -0.2 | 0.1 | -0.4 |
| **France** | -1.0 | -0.6 | -1.6 | -2.0 | -0.6 | -1.4 |
| **Ireland** | 4.3 | 3.8 | 2.4 | 1.8 | -1.9 | -2.0 |
| **Italy** | -0.8 | -0.5 | -1.2 | -1.2 | -0.4 | -0.7 |
| **Luxembourg** | 2.6 | 2.5 | 4.4 | 2.8 | 1.8 | 0.3 |
| **Netherlands** | 1.0 | 1.0 | 1.3 | 0.5 | 0.3 | -0.5 |
| **Austria** | -0.8 | 0.0 | -0.2 | -0.4 | 0.6 | -0.4 |
| **Portugal** | -1.1 | -0.7 | -2.0 | -1.6 | -0.9 | -0.9 |
| **Finland** | 4.7 | 4.4 | 4.8 | 2.9 | 0.1 | -1.5 |
| **Sweden** | 4.6 | 2.1 | 3.9 | 1.6 | -0.7 | -0.5 |
| **United Kingdom** | 0.6 | -0.1 | 1.2 | 0.4 | 0.6 | 0.5 |
| **Euro Area** | -0.6 | -0.3 | -1.1 | -1.4 | -0.5 | -1.1 |
| **European Union** | -0.2 | -0.1 | -0.5 | -0.9 | -0.3 | -0.8 |

*European Commission, Autumn 2001 Forecasts for 2001-2002, European Economy, Supplement A, Economic Trends, No 10/11 - October November 2001.*

Turning to individual Member States, it is apparent that a number of those singled out in the BEPGs for criticism of the targets set for the year, have seen the greatest deterioration in their public finances. Germany, arguably, is where the cause for concern is greatest, not least because its economic weight means that what happens there has a proportionally greater impact on the euro area as a whole. Its deficit is expected to be around 2.5 – 2.6% of GDP in 2001, missing the stability programme target by 1.0% of GDP and the outlook for the year 2002, according to forecasts from the European Commission and the German government itself in the updated Stability Programme at the end of 2001, is no better. In an "alternative scenario", which is in line with the OECD and the European Commission forecasts, the German government admits that the situation is not likely to improve with the government deficit of Europe's largest economy dangerously close to the stability pact criterion of 3% of GDP[34].

Other countries are also likely to diverge from the target of a budgetary position close to balance or in surplus, although as the target is one to be achieved over the economic cycle, rather than year by year, modest deficits need not be seen as alarming. In France, the deficit will be around 1.4 and 1.6% depending on the forecasts, a deterioration compared to the stability programme of 0.4 to 0.6%; in Italy, the deficit target will be missed by 0.3 or 0.4% resulting in a deficit of 1.2 or 1.1% and finally, Portugal's deficit will be around 2.0 or 2.2%, a

[34] Note that the baseline scenario in the programme update foresees a deficit of 2.0%, the alternative scenario projects a 2.5% deficit.

deterioration of 0.9 or 1.1 percentage points compared to the 2000 stability programme update target.

As the European Commission pointed out in early 2001 when assessing the development of public finances in the year 2000[35], these countries have missed the opportunity of a more favourable economic situation in 2000 to pursue budget consolidation in a medium-term perspective: "While this is largely due to welcome reductions in the tax burden, accompanying expenditure reforms have been postponed or toned down in some countries, including measures to modernise pension systems." Given that the economic slowdown has been more pronounced than expected, these increases in deficits are not surprising. Indeed, had the automatic stabilisers not functioned as they did, the scale of the downturn could well have been greater. Nevertheless, many finance ministers might broadly agree with the Commission view and want to return to fiscal consolidation once recovery takes hold.

Other countries (Spain, Luxembourg, the Netherlands, Austria, Sweden, and Finland), however, are expected to meet or outperform the general government balance target set out in their stability or convergence programme updates submitted at the end of the year 2000 or early 2001[36], although in some cases they may have been helped by the cautious assumptions on which the programme updates were based. Spain and Austria are very close to a balanced budget, while Luxembourg, the Netherlands, Sweden and Finland have with comfortable budget surpluses. Another group of countries, i.e. Belgium, Denmark, and Ireland, are expected to keep their budgets close to balance or in surplus even though their budget execution will be lower than expected. For Ireland a marked decline in the budget surplus is expected to continue in 2002, although the fact that it started from a very high surplus has to be borne in mind. With the exception of Belgium, the other three countries have managed to produce substantial budget surpluses. Finally, Greece is in a somewhat exceptional position as the country will miss the government fiscal balance by almost 1.0% ending up with a budget deficit of minus 0.4% according to the Commission (0.3% in the programme update)

In line with the Stability and Convergence Pact, the BEPG advised Member States to prepare budgets for 2002 in keeping with the need to achieve or preserve budgetary positions close to balance or in surplus and to avoid pro-cyclical fiscal policies. Those countries having already achieved these budgetary positions, have by and large followed this recommendation. Major budgetary imbalances seem to have been avoided. Nevertheless, in some cases, especially Ireland and Finland, but also Greece, the surpluses projected in the 2000 update have been reduced significantly. In Finland, the reduction of its cyclically adjusted balance will be substantial in 2002. Less pronounced adjustments to the budgetary balance targets have been made by Belgium (down 0.3% in 2002 according to the programme update) and Spain (0.2%). None of these changes can be regarded as particularly worrying from the point of view of macroeconomic balance, to the extent that they reflect the operation of automatic stabilisers. However, they will mean that progress towards lower public debt, especially by Greece and Belgium will be postponed. Greece has substantially revised the projected debt reduction up to 2004 while Belgium only foresees a temporary slowdown in 2002. Some countries, however, will stick to their projections from the last programme update or have even adjusted the projected fiscal balance upwards.

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[35] European Commission, "Public Finances in EMU 2001", *European Economy* No 3, 2001, p. 2f.

[36] Note that there is a very substantial difference in the projection of the United Kingdom's balance. While the European Commission expects a surplus of 1.2%, the UK, in its convergence programme update predicts a deficit of 0.2% for the budget year 2001/2002.

**Table 4.1.3. General Government Fiscal Balance**
(per cent of GDP, excl. UMTS revenues): Figures according to the 3rd stability and convergence programmes updates 2001

| | 2000 | 2001 | 2002 | 2003 | 2004 |
|---|---|---|---|---|---|
| **Belgium** | 0.1 | -0.2 | 0.0 | 0.5 | 0.6 |
| **Denmark** | | | | | |
| **Germany** | -1.3 | -2.5 | -2 -2.5 | -1-2 | 0.0 -1.0 |
| **Greece** | -1.1 | -0.3 | 0.8 | 1.0 | 1.2 |
| **Spain** | -0.4 | 0.0 | 0.0 | 0.0 | 0.1 |
| **France** | -1.4 | -1.4 | -1.4 | -1.3 | -0.5 |
| **Ireland** | 4.5 | 1.4 | 0.7 | -0.5 | -0.6 |
| **Italy** | -1.5 | -1.1 | -0.5 | 0.0 | 0.0 |
| **Luxembourg** | 6.2 | 4.1 | 2.8 | 3.1 | 3.4 |
| **Netherlands** | 1.5 | 1.0 | 1.0 | 1.0 | 1.0 |
| **Austria** | -1.5 | 0.0 | 0.0 | 0.0 | 0.2 |
| **Portugal** | -1.8 | -2.2 | -1.8 | -1.0 | 0.0 |
| **Finland** | 6.9 | 4.7 | 2.6 | 2.1 | 2.6 |
| **Sweden** | 4.1 | 4.6 | 2.1 | 2.2 | 2.3 |
| **United Kingdom** | 2.0 | -0.2 | -1.1 | -1.3 | -1.1 |

*France: based on cautious assumption (GDP growth of 2.5% in 2003 and 2004). Denmark has not yet submitted its convergence programme update.*

The situation differs with regard to the four countries within the euro area which have sizeable remaining deficits. As mentioned above, the situation is most worrying in the case of Germany which projects a general government deficit of between 2 and 2.5%, with most of the international institutions' forecasts being at the higher end of this projection. For France, the updated stability programme foresees a broadly neutral fiscal stance over 2001-2002 (-1.4%), the European Commission is much less optimistic with a 0.4% deterioration from -1.6 to -2.0%. Portugal's deficit is forecast to decrease compared with 2001-2002, but will still remain above 1.6%. As for Italy, while the Commission projects a deficit of 1.2% in 2001 and in 2002, the government aims at a reduction to 0.5% in 2002. It should be emphasised that all these projections will be sensitive to the overall performance of the EU economy as well as to policy changes. If recovery manifests itself as quickly as, and on the scale that, the forecasters anticipate, the fiscal positions of all countries should be comfortable, but if the slowdown is extended, the risks will be greater.

In some respects, the stability programme updates appear to have been based on relatively sanguine views about recovery prospects. Some measures included in the budgets for the current year 2002 are temporary and do not indicate any major impact on longer-term fiscal sustainability and some consolidation measures might not turn out to be as effective as planned. Thus, if the recovery does not happen as soon as projected in some of the programme updates, in consequences in regard to lower tax receipts, or be higher than projected government expenditure related to the slowdown (for example for unemployment compensation), the safety margins included in the budgets might not be sufficient. The European Central Bank warns in its December report that this might even lead to a deficit ratio above the reference value which "would trigger the preparation by the Commission of a report on the existence of an excessive deficit"[37].

**Table 4.1.4. General Government debt**
(as percentage of GDP)

| | Commission | | | | new SCP | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 1999 | 2000 | 2001 | 2002 | 2000 | 2001 | 2002 | 2003 | 2004 |
| **Belgium** | 115.9 | 110.3 | 107.0 | 103.9 | 109.3 | 107.0 | 103.3 | 97.7 | 93.0 |
| **Denmark** | 52.0 | 46.1 | 43.2 | 42.5 | | | | | |
| **Germany** | 61.3 | 60.3 | 60.0 | 61.0 | 60.3 | 60.0 | 60.0 | 59.0 | 57.0 |
| **Greece** | 103.9 | 102.7 | 99.8 | 98.5 | 102.7 | 99.6 | 97.3 | 94.4 | 90.0 |
| **Spain** | 63.4 | 60.7 | 58.0 | 57.3 | 60.4 | 57.5 | 55.7 | 53.8 | 51.9 |
| **France** | 58.5 | 57.6 | 57.1 | 57.3 | 57.6 | 57.1 | 56.3 | 55.7 | 54.5 |
| **Ireland** | 49.3 | 38.6 | 34.3 | 30.8 | 38.6 | 35.8 | 33.7 | 33.8 | 34.1 |
| **Italy** | 114.6 | 110.5 | 108.2 | 106.9 | 110.5 | 107.5 | 104.3 | 101.0 | 98.0 |
| **Luxembourg** | 6.0 | 5.3 | 5.3 | 5.2 | 5.3 | 5.0 | 4.6 | 4.2 | 3.9 |
| **Netherlands** | 63.1 | 56.1 | 51.8 | 48.9 | 56.1 | 51.8 | 47.7 | 45.0 | 42.0 |
| **Austria** | 64.7 | 63.1 | 62.3 | 61.2 | 63.5 | 61.8 | 59.6 | 57.2 | 54.7 |
| **Portugal** | 54.5 | 53.7 | 53.5 | 53.5 | 53.7 | 55.9 | 55.7 | 55.5 | 54.0 |
| **Finland** | 47.3 | 44.0 | 42.7 | 42.0 | 44.0 | 42.7 | 42.9 | 43.0 | 41.8 |
| **Sweden** | 65.3 | 55.7 | 52.7 | 50.5 | 55.6 | 52.3 | 49.7 | 47.3 | 45.2 |
| **United Kingdom** | 45.7 | 42.8 | 39.3 | 37.2 | 39.9 | 38.1 | 37.2 | 37.0 | 36.8 |
| **Euro Area** | 72.6 | 70.2 | 68.8 | 68.4 | | | | | |
| **European Union** | 68.0 | 64.1 | 62.5 | 61.8 | | | | | |

*Data for 1999 and 2000: Eurostat, structural indicators, last update: 11.01.2002*

*European Commission, Autumn 2001 Forecasts for 2001-2002, European Economy, Supplement A, Economic Trends, No 10/11 - October November 2001.*
*Member States: Stability and convergence programmes updates 2001*
*France: figures based on cautious assumption of GDP growth, Denmark not yet published*

In the aftermath of the slowdown, countries with existing budgetary imbalances will have to take action if they are to uphold their commitment to achieve a balanced budget or achieve a surplus by the end of the current stability programme period, i.e. by 2004. The maintenance of a medium-term perspective in the fiscal policies of the euro area countries is crucial to the overall credibility of the Stability and Growth Pact which, in turn, strengthens the confidence of consumers and investors, particularly in the current context of weaker economic growth. Fiscal consolidation is, inevitably, easier in periods of economic growth, although the experience of the 1999-2000 cyclical up-turn is that some Member States were loath to make some of the changes that might have put them in more favourable positions today.

Finally, the BEPGs recommend that Member States continue to make tax and benefit systems more employment friendly, taking into account the need for fiscal consolidation, and to promote the quality of public expenditure. These supply side ambitions include investing in physical and human capital and research and development, strengthening the efficiency of public spending by institutional and structural reforms, improving the long-term sustainability of public finances by focussing on actions to raise employment rates, the reduction in

[37] European Central Bank, *Monthly Bulletin*, December 2001, Frankfurt/Main, p. 55.

government debt and further reforms of the pension and health system, and finally by pursuing tax co-ordination on the European level. All of these aims are – notwithstanding their "motherhood and apple pie" character – in principle, likely to ease constraints and facilitate the long-term conduct of macroeconomic policy. The real challenge lies in securing the political will to push through these structural policies.

### 4.2. **Invigorate labour markets**

This section of the BEPG 2001 contains the statement that "Member States should take advantage of the favourable macroeconomic conditions to make the necessary structural improvements in labour markets and move towards the goal of full employment". With the benefit of hindsight, it is clear that the statement relied on an overly optimistic assessment of macroeconomic conditions, with several Member States' economies stagnating. In this much more adverse economic context, although structural reforms remain desirable, it is not surprising that the pace has slowed.

While the strong employment performance of recent years continued during 2000 with a net job creation of 1.7% in the European Union, employment growth decelerated substantially during the year 2001. Currently, employment growth in 2001 is projected at only 1.1% with deceleration continuing in 2002 with a projected 0.2% before – under the current economic forecasts – it will pick up again in 2003 (1.0% for the EU-15). Compared to the job creation of 2.4 million in the euro area in 2000, only 3.3 million jobs are likely to be created in the euro area between 2001 and 2003. The employment rate is expected to remain more or less unchanged in 2002 at 62.1% in the euro area. Thus, for the first time since the beginning of the Luxembourg process, job creation will almost grind to a halt in 2002. This means that the Lisbon target of a 70% employment rate by 2010 will be all the harder to meet.

Consequently, while the harmonised unemployment rate has declined further in the year 2001, reaching its lowest level since 1991 (7.8% in November 2001 in the European Union), unemployment is likely to rise in the year 2002 by 0.3% to 8.6% in the euro zone and 8.0% in the EU according to the Commissions Autumn Forecast. The increase in unemployment will be restricted only by the slower increase in the labour force. The projections for the year 2002 expect a reduction of unemployment in Greece alone, while the increase in Ireland and the Netherlands will be higher than in the rest of the EU even if total unemployment there remains substantially below the EU average. Nevertheless, comparing the 2002 forecast with the unemployment rates of 2000, rates will still decrease by approximately 1% in those countries with high unemployment rates, that is in Greece, Spain and Italy, with the exception of Finland (-0.4% over the two years) and France (-0.2%). In Austria, the unemployment rate is projected to increase by 0.5% over the two years, albeit to a rate which is half the euro area average.

It falls to the EU and its Member States to continue with the reform package included in the BEPGs as well as in the employment guidelines in order to insulate the labour market in general as well as the specific target groups from the effects of the global economic slowdown. In recognition of this fact, the European Council in Laeken has recently endorsed the 2002 employment guidelines, the individual recommendations to the Member States and the joint employment report 2001. The 2002 employment guidelines as well as the country-specific recommendations will form the basis for the employment policies in the BEPGs 2002. Nevertheless, only a coherent approach which includes the other policy areas addressed in the BEPGs is likely to achieve a sufficient degree of progress in the labour market.

With regard to the BEPGs 2001, seven general recommendations were addressed to the Member States. Given the rather medium-term nature of the recommendations, Member States have in many cases implemented or are in the process of implementing measures and thus can be said to having responded to the recommendations. However, a thorough assessment of many measures that have been taken can only be made in due time. Still, in most countries efforts have to be intensified and better targeted, while important structural weaknesses remain, especially with respect to the high unemployment levels, in particular amongst young people. Significant gender gaps also remain, as does the low employment rate of older workers in several countries.

**Table 4.2.1.Standardised Unemployment Rates (per cent)**

| | 1999 | 2000 | 2001 | 2001* | 2002* | 2003* |
|---|---|---|---|---|---|---|
| **Belgium** | 8.8 | 7.0 | 6.9 | 6.9 | 7.0 | 6.9 |
| **Denmark** | 5.2 | 4.6 | 4.0 | 4.6 | 4.7 | 4.6 |
| **Germany** | 8.6 | 7.9 | 7.9 | 7.8 | 8.2 | 7.8 |
| **Greece** | 11.6 | 11.1 | | 10.6 | 10.1 | 9.6 |
| **Spain** | 15.9 | 14.1 | 13.1 | 13.0 | 13.0 | 12.1 |
| **France** | 11.2 | 9.4 | 8.6 | 8.7 | 9.2 | 8.7 |
| **Ireland** | 5.6 | 4.2 | 3.8 | 3.8 | 4.5 | 4.5 |
| **Italy** | 11.3 | 10.5 | 9.5 | 9.5 | 9.6 | 8.9 |
| **Luxembourg** | 2.4 | 2.4 | 2.4 | 2.2 | 2.4 | 2.2 |
| **Netherlands** | 3.4 | 3.0 | 2.4 | 2.3 | 3.2 | 3.5 |
| **Austria** | 3.9 | 3.7 | 3.8 | 3.9 | 4.3 | 4.2 |
| **Portugal** | 4.5 | 4.1 | 4.3 | 3.8 | 4.3 | 4.7 |
| **Finland** | 10.2 | 9.8 | 9.1 | 9.2 | 9.4 | 9.3 |
| **Sweden** | 7.2 | 5.9 | 5.1 | 5.2 | 5.6 | 5.4 |
| **UK** | 6.1 | 5.5 | 5.1 | 5.1 | 5.4 | 5.4 |
| **Euro Area** | 9.9 | 8.9 | 8.4 | 8.3 | 8.6 | 8.2 |
| **European Union** | 9.1 | 8.2 | 7.7 | 7.7 | 8.0 | 7.6 |

*Data for 1999, 2000, 2001: Eurostat, structural indicators, last update: 11.01.2002*

* *European Commission, Autumn 2001 Forecasts for 2001-2002, European Economy, Supplement A, Economic Trends, No 10/11 - October November 2001.*

A key challenge for several Member States is the increase in participation among women and older workers in the labour market, although success of recent measures in these fields remains generally low. As central elements in such a strategy, the BEPG 2001 mentioned equal opportunities action schemes, ensuring adequate provision of care facilities for children and other dependants, reforming early retirement schemes and guaranteeing life-long learning. Furthermore, it is necessary to promote the participation of disabled people, ethnic minorities and migrants.

In those countries, where the employment of *older people* is well below the Stockholm European Council's target rate of 50% by 2010, there has been a reform of early retirement schemes, which should keep senior citizens in the work force (for instance in Belgium, Luxembourg, Austria). However, a comprehensive and active ageing policy is still absent in most Member States, while measures taken so far remain highly fragmented and incoherent. Special policies for *young people* have been introduced or are being continued (in France, Italy, United Kingdom) but the planned targets have not been widely met.

Labour market policies have also been targeted in the field of *childcare and other dependent care* (Ireland, Netherlands), for example by increasing child benefit rates (Ireland, planned in Austria) or childcare places (Netherlands), or by focusing on the integration of workers with disabilities (planned in Luxembourg), while other countries still have to considerably improve their efforts (Spain). Also in this respect, not all of these actions, especially those to improve female employability, are sufficient to increase employment up to the levels agreed upon (Spain).

Although the rise in *women's participation* has been rather high in the last few years, this development was based on mainly part-time jobs. It will be necessary to intensify efforts in this respect to achieve the Lisbon target (60% female employment rate by 2010). Currently, with regard to the employment rate of women, comprehensive approaches on gender mainstreaming seems to be lacking in many Member States (especially in Belgium, Italy, Spain and Luxembourg). National targets for female participation in employment – as agreed in Lisbon – need to be established in all Member States.

Activities for the (re-)integration of *ethnic minorities* into the labour market proved partially encouraging (Netherlands, Italy, Sweden), although these measures responded partly to labour market shortages (especially in Italy); generally the situation of minority groups did not improve substantially. Denmark and the Netherlands have set up concrete targets for ethnic minorities.

An important contribution to employment growth is the *reduction of labour charges*, either generally or specifically targeted at labour force segments, that is for example low-paid workers. The tax burden on labour has decreased in several Member States (Belgium, Germany, Finland, France, Italy, Sweden, Spain, the United Kingdom), while wage or non-wage labour costs still remain at high levels in some countries (Austria, Belgium, Denmark, Finland, Germany and Sweden).

Particular emphasis has been placed in a number of countries on the issue of low income levels. By reducing marginal tax rates or by supplementary public funding, also with regard to part-time contracts, employment creation is expected (Belgium, Denmark, Germany, France). Efforts to reduce corporate tax rates have progressed in many countries and will provide further incentives for job-creation. All in all, tax reductions have been modest (except the United Kingdom), probably with the exception of those pertaining to low wage jobs. Some countries will continue to use tax and benefit reform to remove financial disincentives to take up work and postpone early retirement.

Furthermore, reforms to *benefit schemes*, such as those which have limited and tightened conditions for unemployment benefits (Denmark, Finland, Sweden) or disregarded a certain percentage of low level earnings for social assistance calculations (Finland) have boosted still further the incentive to take up jobs, even if the implementation of such reforms made slow progress. Changes to pension schemes further reduced incentives for early retirement (Austria, Finland, Denmark). However, impediments to changes in the established benefit schemes were encountered in, for example, the Netherlands.

With regard to *labour mobility within and between Member States*, major success is still awaiting; the impact of cross-national mobility on unemployment and employment-seeking has been rather disappointing. No substantial figures are presented as to the number of non-national job-seekers in EU countries. In Luxembourg, the possibility of cross-border organisation of apprenticeship training will be considered. The emergence of a European-wide system of job vacancies or even a European wide labour market is still a hypothetical issue, however.

The c*ertification* of skills and capabilities as well as *training schemes* is another way of increasing the employability of people, especially young people (e.g. in Austria, Belgium, Portugal), or of including older people into the labour market (Sweden). In general, this measure should, according to the BEPGS, be linked to a coherent *life-long learning strategy*, which is, however, not in place in all countries (in particular in Belgium, Greece, Italy, Portugal and Spain). In particular, Germany, Greece, Portugal and Luxembourg would have to continue their efforts to provide encouragement to alternative means of training and access to employment, especially in terms of improving the quality of continuing learning efforts. Especially in the field of life-long-learning schemes, the Southern European countries will require considerable effort to implement workable strategies.

*Long-term unemployment* is a problem for a number of countries. While some countries have successfully targeted specific measures to the long-term unemployed, the situation in Belgium, Germany (especially in the Eastern part), Sweden and the United Kingdom for example has not improved significantly. In the Netherlands, long-term unemployed people leaving the benefit system are offered incentives in the shape of a tax-free bonus, while in other countries firms hiring long-term unemployed persons receive exemptions from taxes or social security charges (Italy).

Generally, member countries should be encouraged to intensify their efforts by developing preventive and employability-oriented strategies, building on the early identification of individual needs (as in the case of younger unemployed). In this context, the Member States are called upon to review their public employment services, encouraging cooperation with other service providers.

Measures are required to make *contracts more flexible* and by so doing meet the needs of *target groups*, e.g. by introducing time credit systems (Belgium), part-time practices (Austria, Greece, Italy), or by removing obstacles on part-time contracts (Spain). Not all of these measures have been successful and as such require a more effective implementation (Austria, Germany, Greece and Italy).

The introduction of greater *flexibility* with respect to *wage dispersion*, for example to reflect differences in skills and qualifications between sectors and regions, seems to be difficult. Especially in Belgium, Germany (in particular Eastern Germany), but also in Ireland, Italy and Spain regional disparities are still considerable, while in the United Kingdom the skill gap represents a major problem.

Although the participation of women in the labour market has been on the increase over the last few years, this high level of growth has been built on part-time jobs, a *pay gap* in the private sector of around 15-20%, and persistent glass ceilings in terms of career development and management positions[38]. Although some progress has been achieved in recent years (especially in Austria, Belgium, Portugal and the United Kingdom), much remains to be done in this field in, for example, the Netherlands, Austria, Germany, or Ireland. So far, no country has been able to implement effective measures to reduce substantially the gender gap in payments. The main progress has been made with respect to the preparation of reports and studies, with a view to future policy action (Belgium and Germany).

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[38] Cf. European Commission / Council of the European Union, *Joint Employment Report 2001*.

## 4.3. Ensure efficient product (goods and services) markets

### 4.3.1. *Completion of the Internal Market*

The BEPG 2001 repeated the aim that Member States should achieve deficit *in transposition of internal market legislation transposition* deficits of less than 1.5% before the 2002 Spring European Council in Barcelona. This target was set by the European Council meeting in Stockholm, March 2001, and refers to the internal market's legal framework, now encompassing nearly 1,800 legislative measures as defined by the European Commission. Recent figures published by the European Commission in November 2001 indicate that progress has been made in all but two countries (Sweden and Luxembourg) since the last survey in May 2001[39]. Five Member States currently fulfil the target (Finland, Denmark, Sweden, the Netherlands, and Spain), with Italy being close to the target with a transposition deficit of 1.7%. The Internal Market Scoreboard also notes that progress in Finland, Greece, the Netherlands, Italy and Denmark, has been substantial. On average, the current transposition deficit stood at 2.0% in November 2001.

Those Member States which are not on course to achieving the target by Spring 2002 and those with a negative transposition record in recent months will need to step up their efforts to maintain a truly European internal market for companies and citizens alike. This is especially important for some of the larger countries, i.e. France, the UK and Germany, as they constitute a substantial share of Europe's internal market. The Commission's findings also confirm that only 90% of directives have been transposed in all Member States, and that in some areas, such as transport or consumer policy, the transposition record is still at or well below 75%. The transposition of internal market legislation should also be coupled with other policy strategies. For example, if the European Union and its Member States pay special attention to environmental policy, as agreed in Gothenburg 2001 and included in the European Sustainable Development Strategy, transposition of legislation is a key area in which the Member States can demonstrate their commitment to this long-term strategy.

Finally, plans to simplify and improve the regulatory environment, presented by the European Commission to the European Council in Laeken[40], will lead to an action plan (to be presented in June 2002), which will include proposals to the Member States for a better transposition of Community acts. This initiative within the framework of the White Paper on Governance will also target the European level and thus offers the opportunity for a more coherent approach.

Developments with regard to the *further opening of the public procurement market* are under way in several Member States. The implementation of the public procurement directives in national law has been finalized in some Member States, e.g. in Germany by the implementation of the new ordinance on the award of contracts (VgV, *Vergabeverordnung*) which concluded the transposition of two EU directives in national law. The further development of *on-line availability* has progressed in several Member States, in some Member States pilot projects have started. In several Member States, e.g. in Austria and the UK, administrative reforms enhance the transparency of public tendering. The value of public procurement which is openly advertised compared to the total value of public procurement has increased from 11% in

[39] European Commission, DG Internal Market, "Internal Market Scoreboard", no. 9, November 2001.

[40] European Commission, "Communication from the Commission, simplifying and improving the regulatory environment, COM(2001) 726 final", Brussels, 05.12.2001.

1997–1999 to 15% in 2000[41]. Disparities between the Member States persist, however, ranging from 6% in Germany to levels above 20% in Denmark, Spain, the UK, Ireland and Sweden and Greece (1999 data), with major improvements evident in Austria, Italy and the Netherlands. The ratio of public procurement published in the Official Journal as a percentage of the total amount of public procurement has increased by 36% since 1999. The European Commission finds evidence of substantial progress in Spain, Sweden, the Netherlands, Italy, Austria, Denmark and the United Kingdom in 2000[42]. Most of these countries have continued in their reforms of the administrative execution of public procurement, for example in Austria where the public procurement procedure had been centralised under the control of a single authority.

### 4.3.2. *Reinforce competition*

The opening up of *network industries*, according to strictly defined time tables is required by community directives. In the area of energy supply service, in the last two years, a number of countries have opted for full rather than partial liberalisation. At the moment, approximately 65% of electricity demand in the EU is open to competition, with incumbent operators still maintaining market shares[43]. Some Member States have furthermore enhanced the operation of regulatory authorities with the aim of promoting effective competition in the gas and electricity markets (e.g. the Netherlands and the United Kingdom). On the other hand, concentration has increased in some sectors as companies prepare for a European-wide market, with the consequence that such companies have achieved a more dominant position (e.g. in Sweden). It should be the aim of the institutions to achieve the full opening of the gas and electricity market by the year 2005 in the European Union, provided that this has no negative effect on high standards of environmental protection.

Further steps were taken with regard to the reform of postal services, for example in Finland, Ireland and the United Kingdom. Liberalisation in railway transport has proven to be a difficult task for some countries: customers' dissatisfaction is sometimes very high, a most notable problem having occurred in the United Kingdom with the bankruptcy in October 2001 of Railtrack, the company which owns the track and stations of the rail system.

With regard to the capacity and *effectiveness of the competition and regulatory authorities*, as well as the co-operation between member state and Community authorities, progress is evident in, for example, the recent revision of competition laws in Denmark and the reform of laws in Spain and the United Kingdom.

With regard to both the *reduction of the overall level of State aid* in relation to GDP and the increase in transparency of State aid policies, Member States have made progress in recent years[44]. Between 1997 and 1999, the level of state aid as a percentage of GDP has been

[41] Cf. European Commission, statistical and technical annex to the "Report on the functioning of Community product and capital markets COM(2001) 736 final", Brussels, 07.12.2001, p. 30; and p. 18 in the report itself.

[42] Cf. European Commission, "Report on the functioning of Community product and capital markets, COM(2001) 736 final", Brussels, 07.12.2001.

[43] Cf. for a recent analysis, European Commission, DG Economic and Financial affairs, "Market performance of network industries providing services of general interest: a first horizontal analysis", Brussels, 07.12.2001.

[44] Cf. European Commission, "State Aid Scoreboard, second edition, COM(2001) 782 final", Brussels, 20.12.2001.

reduced by 30%. In 1999 the EU average was about 1% of GPD, ranging from approx. 0.5% in the UK to more than 1.5% in Finland and Ireland. Sweden, the Netherlands, Italy and Greece are below the EU average. Most Member States have gradually redirected aid to horizontal objectives that are not targeted towards specific sectors or specific regions. The most important horizontal objectives concern small and medium-sized enterprises, energy saving, the environment, as well as research and development. In this sense, the recommendations of the European Council meetings in Stockholm and Lisbon to move away from sectoral or regional objectives, underline an already existing trend. In addition, ad-hoc aid has been cut substantially in recent years. With the establishment of the Commission's state aid scoreboard, peer pressure is expected to increase on those members states that do not live up to the targets as well as on those who might undo their progress in economically more difficult times. The *transparency of state aid policies* as well as the reduction of administrative burden has been improved in a number of Member States.

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

Since the adoption of the BEPGs 2001, progress has been made with regard to the *Financial Service Action Plan* (FSAP) on the European level especially with the final adoption of the European Company Statute, the directives on Undertakings for Collective Investment in Transferable Securities (UCITS), the amendment on to the Money Laundering directive and the regulation on cross-border bank transfers, as well as through the establishment of the Securities Committee and the Committee of Securities Regulators. By mid-December 2001, twenty-five out of the forty-two measures in the Action Plan had been completed[45], although the institutions are behind the schedule set by the FSAP for some of the measures. Considerable effort will be needed on the part of Member States to ensure that measures at the national level will be implemented within the specified deadlines.

Significant progress has also been made with regard to the implementation of the *Risk Capital Action Plan*[46], although the integration of EU financial markets is still far from complete. Venture capital investment in Europe has tripled between 1998 and 2000, and investment in early-stage venture capital has increased fourfold. However, venture capital investment as a percentage of GDP in the Member States shows marked differences, with the UK and the Netherlands having reached almost 0.4%, while in Austria, is below 0.1%. Besides improvements on the supply side, efforts are required to bolster the demand side, that is to make it easier for SMEs especially to create new businesses and take up new ideas. The information now available on the time and costs for starting up a new business, showing a considerable reduction in many Member States, should be used by those Member States lagging behind to increase their efforts to reduce administrative and financial burdens.

The global economic downturn as well as current stock markets problems will affect *venture capital investment* and make it more difficult for Member States to press on with reforms to the taxation system. Progress is evident in almost all Member States, especially with regard to tax exemptions, the simplification of the tax framework for venture capital funds, the lowering of capital gains tax on the acquisition of stock options and the exemption of capital gains raised from the transfer of shares and other equity interests. Nevertheless, progress is required

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[45] Cf. European Commission, "Fifth progress report on the Financial Services Action Plan - An Integrated European Financial Market - Europe Must Deliver on Time, COM(2001) 712 final", Brussels, 30.11.01.

[46] Cf. European Commission, "Communication from the Commission to the Council and the European Parliament on implementation of the Risk Capital Action Plan (RCAP), COM(2001) 650 final", Brussels, 25.10.2001.

to facilitate cross-border economic activities, a task which requires further co-operation between the Member States.

Special emphasis was given to the easing of *bankruptcy laws* in the BEPGs. While virtually all Member States have acknowledged the importance of this issue, not all of those having been specifically addressed have started or completed legislative processes to implement this recommendation.

With regard to the *prudential supervision*, several Member States have made progress in continuing either the implementation of recently adapted laws (e.g. Ireland, Austria, Finland) or the legislative process leading to the establishment of, mostly, integrated supervisory authorities for different financial services (e.g. Germany). However, in some countries, new prudential supervision mechanisms have proved to be controversial (e.g. Greece).

## 4.5. **Encourage entrepreneurship**

### 4.5.1. ***Create a business-friendly environment***

Evidence on the *regulatory and administrative environments* provides grounds for guarded optimism[47].Yet, the regulatory and administrative environment differs significantly across the Member States. Data suggest that between 1999 and 2001 there has been a modest decrease in the percentage of firms considering the regulatory and administrative rules to be an obstacle to enterprise performance. At the same time, the dispersion across the Member States has widened with firms in Denmark, Germany, Greece, Luxembourg, the Netherlands and Finland reporting an increase in these constraints. There has been no change in the case of firms in Belgium and in the UK. Firms in the remaining seven Member States firms responded that there had been an improvement. With regard to regulatory quality, which relates to the efficiency, effectiveness and transparency of regulations and related government formalities, several Member States have launched initiatives to simplify and reduce the volume of legislation through, for example, systematic reviews or sunset clauses.

At the same time, Member States continue to introduce regulations at too quick a pace. This is made clear by the notifications of draft technical regulations by the Member States. The number of notifications has grown from 591 in 1999 to 751 in 2000, the figures for the first half of 2001 indicate a slight decrease, albeit from a high level. A large share of companies were dissatisfied in 2001 with the quality of their regulatory environment; many have not yet felt any impact from government's attempts to simplify legislation, particularly companies in France, Germany and Denmark. The main priority areas identified for simplification of the regulatory environment are employment and working conditions (especially in Belgium, Greece, France, Ireland), VAT payments and refunds (especially in Denmark, Finland, Netherlands and Portugal) and product conformity and certification or approval (especially in Germany, Spain, Italy, Netherlands, Sweden and the UK).

Several Member States have taken or continued to apply measures towards a streamlining of the *administrative procedures* related to the setting up of new businesses. Data confirm a trend towards shorter procedures, especially in Member States where the procedures had been the longest. Some improvements, for example in Ireland, have been dramatic. Yet, there remains important scope for progress, by convergence on best practice. The time taken to

[47] Cf. European Commission, DG Internal Market, "Internal Market Scoreboard", no. 9, November 2001.

register a new private limited company in the EU ranges from less than one week up to four months, depending on the member state.

All Member States are engaged in efforts to *promote entrepreneurship*, both within the education system – through courses, business games and visits to companies – and among potential entrepreneurs. In the Netherlands, a consultative commission on entrepreneurship and education has been established, with representatives from the business community, various education sectors and social organisations. France and the United Kingdom have set up a joint club to promote inter-university co-operation in entrepreneurship, while in Spain the government offers grants for university students to follow a six-month programme of practical training in business. All Member States furthermore saw an improvement in their scientific and innovation performance. However, experiences have been diverse. While some countries, such as Ireland, Spain and Portugal, are clearly catching up, those who had already been leading, such as Finland and Denmark, continue to register further improvements in innovation performance. In other Member States, research and technological development and innovation are clearly losing momentum. Although the situation in the four largest EU economies (France, Germany, UK and Italy) is improving, it is doing so at rates below the EU average.

Differences among Member States also persist in the effective rates of *company taxation*. These differences could impact on economic decisions by both discriminating between domestic inward-bound and outward-bound investment and influencing the choice of composition of the investment in terms of assets and of sources of finance. In order to tackle the existing tax obstacles to the Internal Market, the Commission has proposed a two-track strategy[48] involving both targeted remedial measures and a longer-term comprehensive solution consisting of providing companies with a common consolidated tax base for their EU-wide activities. Harmful *tax competition* constituted a major challenge in 2001. On 11 July 2001, the Commission announced the launching of state aid investigations directed at 11 corporate tax schemes in eight Member States, thus adding momentum to the elimination of harmful tax competition in the EU. Luxembourg's finance companies regime and the Netherlands' special fiscal regime for international financing activities are among those to be investigated. The EC also called upon four other Member States to put certain tax regimes in conformity with the EU rules.

On the other hand, *public procurement* markets have become increasingly transparent. The proportion of public procurement published in the Official Journal increased considerably, with significant gains being realised in Spain, Sweden, the Netherlands, Italy, Austria, Denmark and the UK. However, improvements have not been the same in all countries and as a result, differences in the market transparency of public procurement across Member States have grown. Registered awards of contracts resulting from cross-border tendering have also increased. This might indicate that public procurement markets are opening up to international competition

In the field of *VAT harmonisation*, progress has been rather slow. Efforts to simplify the obligations of operators with respect to VAT, has not been forthcoming, since no agreement has been reached on this matter at Council level even though proposals have the backing of the European Parliament, the Economic and Social Committee and operators.

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[48] Cf. European Commission, "Communication from the Commission to the Council, European Parliament, and the Economic and Social Committee, Towards an Internal Market without tax obstacles A strategy for providing companies with a consolidated corporate tax base for their EU-wide activities, COM (2001) 582 final", Brussels, 23.10.2001.

### 4.5.2. *Encourage risk-taking*

The general *financial conditions affecting specifically SMEs* and in particular those SMEs showing a fast-growth profile stand in need of improvement. Of particular relevance for SMEs are measures to reduce costs and red-tape in order to access the deep and liquid capital market in the EU that has emerged since the introduction of the euro. Mutual guarantee societies are a possible solution to public guarantee schemes to solve the problem of obtaining bank loans for enterprises lacking collateral. The special exemption schemes on VAT applying to small businesses, which differ widely from one member state to another are in need of an overhaul.

Prospective small businesses encounter a variety of logistical and financing problems in getting going. Around a quarter of SMEs in the EU encounter difficulties in surviving. The worst problems seem to arise in Greece and in Portugal. However, in several Member States – Belgium, Ireland and the Netherlands and, to a lesser extent, Austria, Finland, Sweden and the United Kingdom – SMEs emerge as much more confident, focusing their activities on improving quality, innovation and profitability. While most SMEs reported no constraints on business performance over the past two years, several reported difficulties with administrative regulations, while others pointed to problems in gaining access to finance.

*Business angels* (informal private investors) can play a crucial role in helping SMEs. It is only in recent years that networks of *business angels* (BANs) have been formed. Evidence shows that between 1999 and 2001 there has been a 25% increase in the number of BANs across the EU, to 130. The importance of BANs in supporting and sustaining growth of SMEs lies in their contribution to resolving financial, managerial and information problems. Providing an environment that is conducive to the formation of BANs or similar sources of guidance for small firms and entrepreneurs is one of the challenges which face Member States.

## 4.6. **Foster the knowledge-based economy**

### 4.6.1. *Promoting Economic Growth*

*Information and communication technology (ICT)* is having a profound impact on the potential for economic growth, being one of the main sources of competitiveness and increases in incomes[49]. The sectors with the strongest medium-term employment growth at EU level have been and continue to be those characterised by either high technology or ICT-related jobs and/or by high knowledge intensity as reflected in the high educational levels of the workforce. Differences in productivity growth between EU Member States are not only the result of different use of ICT, but in some cases also reflect a catch-up process, especially by countries like Greece, Finland and Ireland, as compared to Denmark, the UK, Germany, or Luxembourg.

Despite the recent downturn of the economy, Europe's long-term demand for people with ICT skills remains strong. Estimates indicate that the ICT skills gap would widen to 1.5 million workers by 2003.

A central question is how, specifically, the ICT and e-business skills gap affects enterprises, notably SMEs – both ICT and end user industries. There is a particular need to close the supply and demand gap rapidly, and provide concrete solutions to help EU enterprises adapt

[49] Cf. European Commission, "Communication from the Commission to the Council and the European Parliament, The Impact of the E-Economy on the European Enterprises: Economic Analysis and Policy Implications, COM 2001 (711) final", Brussels, 29.11.2001.

to the e-Economy. Enterprise-focused policy actions should concentrate on concrete and pragmatic solutions. In this respect a number of tools should be explored, including tax incentives for mobility and maximising the range of skill development tools used by enterprises (e.g. knowledge networks, and corporate universities or skills programmes set up by industry and business schools).

### 4.6.2. *Stimulate R&D and innovation*

The transition of the European Union into a knowledge-based economy has begun, but it still lags significantly behind the United States and Japan. Deficiencies in areas such as investment in new technologies, high-tech patenting and internet penetration are still remarkable. The gap between US high-tech patenting in Europe and European patenting in the United States is still large.

Recent figures underline that although *R&D investment* is an important contribution in the direction of a transition to a knowledge-based economy, the overall spending on R&D measures in the European Union has failed to improve substantially in recent years. In the context of a stagnating economy, expenditure remains at 1990s levels. The variation between EU Member States has even increased, showing a considerable north-south "cleavage". While some countries are firmly situated above the EU-average of 1.9% of GPD (in 2000)[50], that is for example Sweden, Finland, Germany and France, others are below 1% in overall R&D spending (Greece, Portugal and Spain). Both business (at 1.2%) and public expenditure (at 0.7%) have made scant progress in recent years.

In some EU Member States, targets have been set in order to increase the R&D quota (e.g. the UK, aiming at 2.5% of GPD by 2005), complemented by additional funds and tax incentives for businesses. In Germany, a University Initiative for the Future has been financed from the UMTS-linked interest savings. In France, the government has prepared the basis for a closer cooperation in R&D between the public and private sectors, including the setting up of seed capital funds. Also within the framework of the Risk Capital Action Plan, measures have been implemented to encourage businesses to increase their expenditure in innovative fields.

It is essential that European competitiveness be strengthened: timetabled policy steps to facilitate a *knowledge-based economy* have to be increased, a business climate supportive of innovation has to be set-up; venture/risk-capital, that will encourage investment, has to be provided. In this context, it is necessary to raise private sector involvement contributing to a better commercialisation of R&D results and to the establishment of a European Research Area. Programme. For Member States that are major beneficiaries of EU structural funds, programmes and investments have to be set up; the framework for high-tech patenting needs to be improved, ties between university and business leading to knowledge transfer and a better commercialisation of R&D results should be established.

### 4.6.3. *Access and use of ICT: education and learning*

The necessity of *access to and use of ICT technologies* has gained much attraction in discussions and debates in EU Member States recently. The percentage of households with acess to the Internet at home has risen steadily from 28% in 2000 to 38% in 2001. This trend is asymmetrical, however, with northern EU countries achieving a figure of over 50% (Denmark, Sweden and Netherlands at above 60%), whilst southern countries lag behind

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[50] Eurostat estimate.

(Greece at around 10%, Spain and Portugal below 30%). Some Member States have reacted to this challenge. For example Spain has made progress through the development of a regulatory framework for the ICT sectors as well as the development of e-Administration and further taxation measures to foster investment. A large number of Member States have put a special stress on e-government, education and research as well as on the organisation of work and electronic commerce. Nonetheless, northern countries, such as Sweden, remain at the forefront as regards ICT-related production and internet usage.

A special emphasis was placed in 2001 on *e-Learning measures*. While in the past, training in information technology (IT) skills was the mainstay of E-learning –covering at present 76% of all offers– other industry areas as well as governments and administrations are moving into this area. It is necessary to provide internet access to pupils in schools and students in university; to improve the compulsory training of teachers and academic staff; to establish further steps helping to reduce the costs of internet usage; to accompany the strengthening of the regulatory framework for e-commerce by a vigorously promoted and far-reaching communication strategy.

The latest developments in education and training efforts can particularly be seen in the PISA study. The study, the most comprehensive international survey ever undertaken, shows that the results of many EU Member States – with the exception of Finland – are not satisfactory.

Some Member States have reacted to the shortcomings. As the example of Portugal shows, efforts have been taken to reinforce the advanced training of human resources in Science and Technology as well as initiatives to encourage the co-operation between entrepreneurs and R&D systems and a new R&D program consisting of a joint venture between corporations and research institutions.

In this context, detailed analysis of *life-long learning requirements* in the knowledge-based society will entail redefining basic skills, to include, for instance, the new information and communication technologies and of foreseeable employment market trends. The analysis should include the specific needs of groups, which have been excluded from training and education as well as the adaptation requirements of teachers and trainers.

Certain countries, especially Finland, the Netherlands and Spain, strongly emphasise the innovative potential of ICT for teaching and learning and are investing considerable resources and effort into this field. The e-Luxembourg initiative, for its part, illustrates policy and action on a broad front in favour of integrating ICT into the education and training domain. It includes curriculum reform, teacher training and re-training, matching learning pathways to new occupational profiles in the Information Society, demystifying ICT and motivating potential learners to take up digital literacy courses with the help of local multi-purpose learning centres. The production of quality ICT–based learning materials preoccupies some of other countries – with diverging views on how quality may best be assured. There is obviously no best way. "Best practices" should be compared but carefully evaluated in terms of the respective national characteristics in this field. Due to resistant traditional patterns imports might not work in the desired direction; lessons for other countries need to be drawn carefully. Sweden clearly states that monitoring quality is a national (rather than European) responsibility. Finland, on the other hand, does not favour any regulatory system, on the grounds that monitoring quality is a professional responsibility for individual education and training practitioners themselves. However, the United Kingdom is keen to develop Europe-wide quality-control standards for ICT-based methods and the personnel engaged in developing and using these, including a quality mark for ICT-based materials, capable of working in concert with European procedures for mutual recognition[51].

## 4.7. **Enhance environmental sustainability**

The general recommendations of the 2001 BEPGs included recommendations on environmental sustainability. These concern the implementation of the European Sustainable Development Strategy agreed by the Gothenburg European Council meeting, the introduction and strengthening of market-based policies, the reduction of sectoral subsidies and tax exemptions which have negative environmental impact, efforts to fulfil the requirements of the Kyoto Protocol and a call for an agreement on the European level on an appropriate framework for energy taxation. The following overview presents some of the measures taken recently by Member States, partly on the basis of the recommendations, partly as a continuation of policies already decided upon.

With its 1999 electricity reform *Denmark* introduced – besides the liberalisation of the electricity market – a system of tradable – transferable emission permits for $CO_2$ emissions ($CO_2$ quotas) from the electricity sector as from 2000. The first quotas have been determined for 2000-2003. Additionally, a report on the green market economy was prepared in 2001, in order to analyse the possibilities of introducing market-oriented tools for the promotion of environmental protection. As to the overall Danish energy policy, the use of marked-based instruments – such as taxes and marketable quotas – is increasing. In the area of waste taxes, product specific taxes are used to reduce consumption and waste quantities.

*Germany* carried on shifting the tax burden from labour to energy. The Eco-Tax is the main measure taken to enhance environmental sustainability in this regard. Additionally, the German government reached an agreement with the energy supply companies in June 2000 to terminate the use of nuclear power after the next 32 years. No new nuclear plant will be approved. The German government encourages the creation and use of renewable energy sources. Thus, private investors in wind energy benefit from tax exemptions. With the feed-in arrangements in the wind energy sector, premium prices for power purchase are guaranteed by additional public funding, which should give investors confidence for further investments in the wind energy market. As to solar energy, Germany will finance its "100 000 roofs programme" from 1999-2003 with € 560 million, providing an essential incentive to the photovoltaic industry. In order to further promote voluntary environmental protection and management within companies, the German government in January 2002 agreed upon a draft for a new law on EMAS (Environmental Management and Audit Scheme) Eco-Audit to provide additional incentives for companies and firms to join EMAS (no longer every site will then be evaluated separately, but numerous sites of the same company will be evaluated and registered as one). Presently, a national strategy for sustainable development is drafted by the government in order to merge environmental, economic and social goals and to integrate intermediate actors in the implementation of these goals.

In *Greece*, the energy sector has been stimulated by tax exemptions and reductions for the investment in or use of renewable-related energy products like solar thermal water-heating. This sector is moreover funded by subsidies from the public side.

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[51] Cf. CEDEFOP, "Memorandum on Lifelong learning Consultation Process: A Review of member state and EEA Country Reports", Thessaloniki, October 2001 (to be published in 2002 in the CEDEFOP Panorama Series).

In *Spain*, companies are provided tax relief for investing in renewable energy projects and at the same time the public sector funding through the Energy Savings and Efficiency Plan has been reduced due to the overall success of wind energy.

In *France*, the implementation of the recommendations is in progress. Tax credits to reduce global warming (tax credit for thermal insulation outlays; tax credit for the purchasing of low-polluting cars) have been implemented as well as lower taxes for firms investing in power-saving equipment. Additionally, the growth of the French biofuels industry is supported by the application of lower fuel excise duty rates to biofuels; French financial support for biodiesel was nearly € 120 million in 2000.

In relation to the goal of environmentally sustainable development, the *Irish* Department of the Environment published a Sustainable Development Plan in November 2000 to look into how Ireland intends to implement the Kyoto Protocol. However probably due to the main goal to reduce inflation, indirect tax measures like tradable emissions permits or carbon or nitrogen taxes were shelved in the last budget. Although the National Development Plan requires all projects to be subjected to an Environmental Impact Assessment plan, in essence, little has been done of a fiscal nature to encourage environmentally sustainable growth.

In *Italy*, parts of the revenues received from energy taxes are used to benefit energy efficiency or other environmental projects. Additionally, the "10 000 roofs programme" (similar to the German "100 000 roofs programme") supports (by additional public funding) changes in consumption habits in the energy sector towards the use of renewable energies. On the other hand, the increase of excise duties with regard to an environmental tax reform has been abandoned.

In the *Netherlands*, the trading system for industrial NOx emissions has been linked to a voluntary agreement with the industry to reduce NOx intensity of emissions and energy consumption.

In *Austria*, an energy tax on natural gas and electricity was introduced, and ecological elements were integrated into transport taxation. With regard to private energy consumption, the doubling of the electricity tax as of June 2000 counterbalanced to some extend price reductions resulting from market liberalisation in this area. Furthermore, EU law and low harmonisation in the area of taxation hindered further integration of environmental aspects in important areas of fiscal policy. Currently the issue of increased use of environmental taxes is intensively discussed at the national level.

In *Finland*, the taxation will shift in the future toward capital, property, environmental and energy taxes. The government is currently especially concentrating on how environmental and energy taxation can be used to implement the Kyoto protocol.

In *Sweden*, taxes on $CO_2$ emissions and energy (with the exception of biomass) support the increase of biomass district heating and biomass combined heat and power plants. The taxes especially raised the prices of coal-fired heating and coal-fired combined heat and power plants. Generally, in Sweden, biomass is excluded from energy, carbon dioxide and sulphur oxide taxes.

In the *United Kingdom*, the government has responded to the BEPG's stress on sustainable development by introducing a Climate Change Levy (CCL). The 2001 budget introduced the CCL, a tax on non-domestic users of electricity, gas, liquefied petroleum gas (LPG) and solid fuels. This measure is significant in helping the UK to meet its commitments under the Kyoto Protocol. The government is, however, under pressure to modify the measure because of its impact on energy-intensive business. As a result, the governments fuel price escalator, which is designed to discourage excessive use of motor vehicles has been abandoned following disruptive fuel protests in the autumn of 2000. In addition, the practice of emissions-trading also plays an important part in the UK's environmental policy strategy. The 2000 Spending Review sets aside 2000 £30 million over the period 2003-04 to provide financial incentives for firms to join the Emissions Trading Group.

First conclusions are difficult to draw based on the variety of measures taken and fields of action proposed. Nevertheless, a modest shift towards the application of market-based instruments in pursuit of environmental objectives can be observed, the support for technological innovation is being pursued by Member States. As many measures are still fragmented, the development or implementation of a national sustainable development strategy is still to be achieved by most Member States. "Mainstreaming" measures on the national level, as on the European level, are very rare.

Comparing the recent national developments with the contents of the BEPG's recommendations for sustainable development, further reforms are needed. The integration of sustainability as a major principle of economic and fiscal policy into the Member States' national policies will be the key challenge for Member States in order to support innovation and investment, and to create and combine environmental as well as economic and social benefits. The assessment of the economic, social and environmental dimensions also have to be incorporated in the planning of new policies. It should include further market reforms, including targeted taxation, concrete measures to raise revenues for environmental purposes, and the broad use of sustainability impact assessments for all major policy proposals. The introduction of national strategies for sustainable development should finally lead to a coherent "mainstreaming" of relevant sectoral policies.

## Chapter V – *OVERVIEW ON THE IMPLEMENTATION OF COUNTRY SPECIFIC RECOMMENDATIONS IN THE BEPGS AND THE SCPS*

### 5.1. **Belgium**

With regard to **budgetary policy**, due to the global economic slowdown, which in particular affects Belgium as an export-oriented country (export growth was down to 0.8% in 2001 from 9.7% in 2000), and lesser private consumption, Belgium will not be able to achieve the targeted 2001 budget surplus. However, a balanced budget (including UMTS-proceeds) is expected; without these proceeds the budget will be close to balance with a slight deficit of 0.2% of GDP. This result has been achieved not least by the extraordinary budget control exercise in July 2001 and in the light of a substantial downward revision of GDP growth targets (1.1% in 2001 instead of 2.5 as projected in the 2000 update of the stability programme)[52].

While the government and the European Commission project an identical GDP growth for 2002, i.e. 1.3%, the projections for the fiscal balance differ. The government, in line with the OECD projections, expects to secure a balanced budget. The European Commission is slightly more pessimistic with a deficit of 0.2%, but in both cases it is lower than the 0.3% of GDP surplus aimed at in the last programme update. Total expenditure will stay within the projections. The updated stability programme foresees a primary surplus of 6% for 2002, in

[52] Belgium's Stability Programme 2002-2005, November 2001, p. 11.

line with the BEPG recommendation. While the gross debt ratio, which has decreased to 107% in 2001, is projected to further decrease to 103.3% in 2002, albeit at a slower pace, the target for 2005 of 88.6% remains practically unchanged. Nevertheless, the underlying projections in the programme update leading to the fulfilment of a balanced budget in 2002 are rather optimistic. Indeed, real general government primary expenditure is likely to increase beyond 1.5% – a major benchmark – in 2001 and in 2002. In part, this is due to the implementation of reforms, especially the income tax reform, but also a consequence of expenditure increases in health care[53].

Belgium has made progress with regard to the pension reform in 2001 with the Ageing Fund being established in September 2001 which will benefit from budget and social security surpluses, non-fiscal revenues (such as the UMTS processed in 2001) and income from investments effected by the Ageing Fund. The strategy to achieve sufficient financial sources to cover the costs of the ageing population will however rely heavily on the continuation of debt-reduction and thus on securing sustainable finances in the long-term.

With regard to the **labour market**, Belgium has continued to reduce labour charges, especially those concerning young people and the elderly. Until now, however, the tax burden on labour remains one of the highest in the EU and employment amongst older workers is still the lowest in the EU. Tax incentives are planned in the budget year 2002, e.g. amending personal income tax, i.e. allocation of a tax credit to low income earners to promote their (re)entry in the labour market raising the net income of low paid employees via a reduction in their social security contributions. As a measure to maintain older workers on the labour market, the tax reduction presently granted to pensioners and pre-pensioners will be halved for the "new" pre-pensioned. Whether these new measures to provide positive incentives to stay at work will indeed significantly reduce early exit from work, remains to be seen. Still, the tax burden on labour remains one of the highest in the EU.

In order to support youth employment and strengthen education and training, a "young person's first job" scheme came into operation in April 2000. Enterprises employing more the fifty people must take on a number of young people under a "first job" agreement. The 2002 budget proposal also includes a measure to link the payment of young people's "minimex" to a training obligation. As to the regional disparities in employment, they are difficult to eliminate given the language barriers, the cost of moving and the uprooting of family life.

Belgium continued to make efforts to increase participation rates of women and older workers, an attempt which is directly linked to a generally low employment rate in these categories. Several measures were taken in this respect, among other, a time-credit system allowing career interruptions for 3 months minimum and 1 year maximum, the possibility for older workers to opt for an indefinite half-time career break, increasing tax allowances for child-care costs and adapting the cost of child-care to revenue. Negotiations are being held in the education sector to increase the "exit" age of teachers from 55 to 58 years. A working time reduction on full pay for older workers in the health sector is now being implemented.

The pace of reform in the **product market and the knowledge-based economy** has not been substantial. In the gas and electricity sector which, according to the BEPG, should be opened up to competition, not much progress has been achieved. The bill for the household consumer remains high. As to wholesale users, they are not able to benefit from increased foreign (i.e. German) competition because of a lack of import capacity at the Belgian borders.

[53] Cf. IMF Article IV consultation on Belgium, preliminary conclusions, 26 November 2001.

The collapse of SABENA, the envisaged closure of 400 post offices and the financial problems of the Belgian railroad system have provoked a debate within the coalition government (liberal, socialist, green) on how to address the problems of autonomous companies i.e. companies that provide universal services and are being run by independent managers with the public authorities as major or sole shareholders. Currently discussed are options to improve the quality of the oversight by the public authorities or to privatise further.

As to the alleviation of the administrative burden on businesses, that is the reform of federal public administration, progress is slow. A recent report mentioned that it takes, on average, 90 days to set up a business and acquire all the necessary (8) certificates.

As regards **capital markets** and financial services, the government and social partners have agreed on a draft law (to be implemented in 2002) on a "second pension pillar", i.e. complementary group pension capitalisation at sectoral or enterprise level. A law was also passed in 2001 permitting employee participation in the capital of their enterprises. The self-financing of the SMEs has been promoted by a partial tax exemption on reinvested profits. A task force has been set up to facilitate SMEs' access to financing. Supervisory structures have been revised along the lines of the Lamfalussy report on the regulation of securities markets.

Euronext, i.e. the merger of the Brussels, Paris and Amsterdam stock exchanges allowed the Belgian companies – operating so far on a modest-sized market – to trade on a wide, liquid market. This should support the exceptional growth of the private equity market. The economic downturn is provoking a financial one: banks who added financial intermediation and insurance to their core business are presently issuing profit warnings. It also affects SMEs' access to bank credit. The degree of concentration of the Belgian banking and insurances sector is presently very high.

## 5.2. Denmark

With regard to **budgetary policy**, the significant downward revision of GDP growth due to the international economic slowdown will particularly affect the surplus in the general government finances. It is expected to be somewhat lower than previously estimated, in particular in 2002 and 2003. Government surplus in 2001 is predicted to stay at around 2.0% (as opposed to the 2.8% target in the convergence programme update in 2000)[54]. The main contribution to the reduction of the government surplus has to be attributed to lower tax revenues from enterprises as well as from pension companies. Current forecasts predict that real growth of government consumption will stay below the projected 1.9% with the European Commission and the OECD assuming a 1.7% rise.

The European Commission's Autumn 2001 forecast is broadly consistent with the Government's revised projection of October 2001. It is, however, noteworthy that the Commission forecasts a significantly higher budget surplus in 2002 (2.1.% of GDP vs. the Government's estimate at 1.6% of GDP). As the Ministry of Economic Affairs[55] points out, the surplus on general government finances in 2002 is expected to be reduced by almost 1% of GDP mainly due to the loss of revenue from taxation of pension capital stemming from the decline in equity prices. The Danish Economic Council[56] also notes that "a main reason for the

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[54] European Commission, "Autumn 2001 Forecasts for 2001-2002", *European Economy*, Supplement A, Economic Trends, No 10/11, October/November 2001, p. 42; Danish Ministry of Economic Affairs, Revised short term forecast for Denmark, October 2001.

[55] Danish Ministry of Economic Affairs, Revised short term forecast for Denmark, October 2001.

[56] Danish Economic Council, 2001, *Dansk økonomi, forår 2001*.

fall [in the government surplus from 3% of GDP in 2000 to 1% of GDP in 2002] is the lack of revenue from taxation of returns in pensions funds following the drop in stock prices during this year". It is also noteworthy that the various forecasts largely agree that the economic slowdown will not affect the unemployment rate significantly. This can be attributed to the fact that the Danish labour market is very tight with a very high degree of capacity utilisation.

As already noted in the updated convergence programme of December 2000, the general government finances are quite sensitive to market fluctuations. Estimates indicate that decreases in GDP of 1% below the trend development of GDP worsen the balance by approximately 0.8% of GDP. According the projections made by the Danish Economic Council (2001a), the Government will not reach its target of a budget surplus of above 2% of GDP in any of the years up to 2004[57]. The medium and long term policy framework in particular focuses on budgetary policy and labour market policy. The impact of ageing of the population on the labour market is clearly the greatest challenge in the longer run. If the labour supply is not raised in the coming years, labour's contribution to economic growth will be reduced significantly and this will make it more difficult to meet the fiscal requirements stemming from the demographic shifts[58].

In light of the expected increase in the share of elderly people in the population beyond 2005, it is a high priority for the Danish government to run a surplus in general government finances of 2-3% of GDP up to 2010 so that the ratio can be further reduced to around 25% in 2010. This is a precondition for meeting the challenges from the ageing of the population without future tax increases or reductions in public services.

Denmark has problems in complying with the recommendation on local government consumption, in line with the Council recommendation contained in its opinion on the 2000 updated on the convergence programme to strengthen the institutional framework. As the constitution grants local government a wide degree of independence and co-ordination between central and local government on the overall level of expenditures and taxes is based on voluntary agreements (the agreements being not legally binding), it is difficult to implement these recommendations without violating the constitutional independence of local government.

With regard to the **labour market**, the implementation of the 3rd stage of the labour market reform continued in 2000 and 2001. The shortening of the total benefit period from 5 to 4 years and the advancing of the right and duty of activation was completed in early 2001. The Finance Act for 2001 contained minor adjustments of the labour market reform, including new instruments of active labour market policy, aiming to facilitate a more effective job search. A reform of the early retirement scheme, inducing senior citizens to postpone their retirement from the labour market, was implemented in 1999. In December 2000, agreement was reached on another early retirement pension reform. This reform, coming into effect in 2003, will simplify the early retirement pension system and support the active line, with as few people as possible on passive maintenance. This reform assumes that an intensified effort will be made to create more flex jobs (i.e. jobs with salary supplement) so that more people with reduced fitness for work may be employed.

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57 Note that any reference to the year 2002 are based on the proposal by the former government. With the elections, the Finance Act proposal for 2002 is automatically rejected. The publication of Denmark's update of the convergence programme is foreseen for the end of January 2002.

58 Cf. Danish Economic Council, 2001, *Dansk økonomi, Efterår 2001*; and Regeringen, "En holdbar fremtid – Danmark 2010", 2001.

Another part of the structural reform of the labour market is the tax inducements included in the Whitsun package, i.e. a reduction of marginal taxes at low income levels (to 43.5% in the year 2002)[59]. The lowering of income taxes levied by central government is however partly offset by the rise in income taxes to lower levels of governments. One problem still remaining on the agenda is the better integration of ethnic minorities into the labour market.

On the **product markets**, several initiatives have been taken to intensify competition, not least in retail trade. Liberalisations are thus being made in respect of shop opening hours and in the pharmacy sector. Increasing public sector efficiency is centred on an increased use of procurement, not least by the recently established Public Procurement Portal. The public research efforts have also been considerably strengthened. Through the revision of the Competition Act, the Competition Council has since 1 October 2000 had the authority to apply the provisions of EC treaty articles 81 and 82. Denmark thus complies with the specific recommendation in BEPG 2000 to continue to take action to strengthen competition policy and make sure that it is enforced in full and to give the competition Council powers to enforce EC articles 81 and 82. Thus, the BEPG may have had an effect in inducing this policy reform.

There exist, however, a number of areas in which the competition on the product markets can be intensified. In the Competition Report 1999, 51 sectors were identified in which competition were insufficient. It is the Government's ambition that the number of sectors with competition problems is to be halved by the year 2010. Furthermore, there is still a large potential in the public sector for introducing tender arrangements.

On **capital markets**, a number of initiatives have been implemented, i.e. initiatives which have made it easier for financial companies to participate in the internationalisation. For instance an improvement of the supervision of financial groups has been implemented and limitations on ownership structure have been repealed. A Bankruptcy Council, established in 2001, will present recommendations for a reform of the Danish Bankruptcy Act.

Furthermore, framework conditions on the stock market have improved. Elsewhere, a bill has been proposed on a flexible share ceiling based on the prudent man principle, as well as a bill on the establishment of specialised funds for investments in small innovative enterprises. There has been a substantial increase in Danish venture capital investments in recent years.

## 5.3. **Germany**

With regard to **budgetary policy**, the situation in Germany is of increasing concern. First of all, the target to attain a general government deficit of 1.5% of GDP in 2001 will not be met. The updated Stability Programme of Germany now forecasts a general government deficit of around 2.5%, in line with the major forecasts of the European Commission, the OECD and the IMF. In addition to a projected GDP growth of only 0.75%, which is 2% lower than projected in the last programme update, several other factors have contributed to this sharp rise in the government deficit. The programme update refers to the revised deficit in the year 2000 from 1% to 1.3% which affects the government fiscal balance of 2001[60], as well as to increased expenditure for the *Bundesanstalt für Arbeit*, an increased expenditure in the social security payments, especially the abolition of expenditure ceilings for the drugs' budget in the health sector contributes to a high deficit in this sector, and a sharp decrease in tax revenues based on

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[59] Cf. European Commission,"Public Finances in EMU 2001", p. 122.

[60] as it affects the borrowing requirements of the general government sector, now projected to read 2.5% of GDP in 2001; cf. European Commission, "Autumn 2001 Forecasts for 2001-2002", *European Economy*, Supplement A, Economic Trends, No 10/11, October/November 2001, p. 21.

the economic slowdown. Government expenditure is expected to grow by 1.5% in 2001[61]. A further deterioration of the government deficit in the year 2001 was prevented by a realization of proceeds from the sale of government holdings accumulating to approximately 0.5% of GDP[62].

In the light of the current difficult economic situation, Germany will not meet the targeted reduction of the general government deficit in the year 2002 of 1%, but instead is now aiming at a deficit of approximately 2%[63]. The updated stability programme makes clear that this target will be difficult to meet, as it maintains the year-on-year reduction of 0.5% of the deficit as projected in the 2000 update. One of the major uncertainties will be the development of tax revenues in the year 2002, already taking into account the marked downward revision by the November *Steuerschätzung* of € 9.8 bn for 2002. In addition, financial strains in the pension and unemployment insurance systems will almost certainly reduce further the room for manoeuvre. Nevertheless, net borrowing in 2002 is to be held unchanged at € 21.1 bn. The major international institutions are much less optimistic than the German government with regard to the government deficit in the year 2002. The European Commission is projecting a 2.7% deficit while the IMF in its December update and the OECD envisage a 2.5% deficit. These projections position the fiscal situation of Germany very close to the 3% deficit criterion of the Maastricht Treaty. The government has responded to these diverging projections by including a sensitivity analysis in the programme update based on a 0.25% higher average annual expenditure growth as well as a lower growth assumption. In both cases – as well as in the combined case – the deficit projection for the year 2002 is in line with the 2.5% projection of the IMF and the OECD.

Nevertheless, the Government maintains that it is on target to achieve a balanced general government budget by the year 2004, in line with the Stability Programme, although it declares this aim to be "extremely ambitious" and depending on the development of the expenditure at all levels of government. In addition, the government hopes to achieve a balanced budget at the federal level by the year 2006, taking into account the further reduction of income taxes in the year 2005, a reduction already adopted in the framework of the tax reform of the year 2000[64].

In order to reinforce budgetary policy coordination among the various levels of government, the *Haushaltsgrundsätzegesetz* (Law on Budgetary Principles for Federation and Länder) has been change by the institutions. While both the Federal and the Länder level commit themselves to reduce net borrowing with the aim of achieving budget balance, the *Finanzplanungsrat* (Financial Planning Council) which also involves the main sub-national actors (*Länder* and *Gemeinden*), has been allocated new tasks. It will now be able to make recommendations both on a joint expenditure line for Federation and Länder as well as in the event of a need to restore budgetary discipline. This new "arrangement" is not however a national stability pact, nor will the recommendations of the *Finanzplanungsrat* have a binding character.

The pension reform has been adopted and its implementation started on 1 January 2002. As the Commission implementation report for the BEPG 2000 already stated, the pension reform

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[61] German Stability Programme Update, December 2001, p. 20.

[62] German Stability Programme Update, December 2001, p. 25.

[63] The updated programme assumes a GDP growth of 1.25% in 2002.

[64] Note that the sensitivity analysis of the programme update deviates from this target by indicating a general government deficit of 1% in 2004 and 2005.

"represent an important, albeit in the long-term not sufficient step in this direction"[65]. Also the reform of the health sector has not been pursued satisfactorily in the year 2001 and contributions to the medical care insurances had to be increased at the beginning of the year 2002.

Also in the area of **labour markets**, the developments in the year 2001 are rather mixed. Some active labour market policies were adopted in 2000 to improve the efficiency of active labour market programmes, directing € 21.7 bn to infrastructure measures mainly in the new *Länder*. In order to obtain precise information on the effectiveness on these measures and to improve them, the German government has asked a "Benchmarking Group" (within the *Job Alliance*) to study active labour market policies theoretically and empirically, which submitted its critical report in September. The German government has announced, however, that it will look at the conclusions and review its active labour market programmes. The new Job Activation Law of the federal government will focus on a reorientation of the concept of job placement and advisory services. Nevertheless, improvements especially with regard to the situation of the long-term unemployed (in particular in the Eastern part of the country) are unsatisfactory, with the employment rate below now the EU average and no improvements in the last few years. No progress is evident with regard to wage dispersion to reflect differences in skills and qualifications between different sectors and regions, while wage growth has continued to be modest in 2001. The prospects for the year 2002 are, however, uncertain, partially as a result of the upcoming general elections.

On the issue of further reforms of the tax and benefit system (especially for low-wage labour) and lower non-wage labour costs, the Ministry of Finance argues that the second and third stages of the Tax-Reform will have a strong impact on the low-wage sector: The basic tax-free allowance will rise and the basic tax rate will be reduced from 25.9% to 15%. Some model projects have started to reduce wage costs at the lower end of the pay scale, which have not yet been fully evaluated. Most recent announcements of the government (as of January 2002) indicate that even without an in-depth evaluation, some of these projects are bound to be extended. One of the main priorities of the current government has been to stabilise non-wage labour costs. It had been successful until Autumn 2001, when contribution rates to the mandatory medical scheme started to rise.

In the field of **product markets and the knowledge-based economy**, various new initiatives have been launched and others implemented. In December 2000, the Law on Discounts and the Ordinance on Premiums was repealed. This measure may be influenced by the opening of European Markets and the single currency: it is meant to insure equal competitive conditions for suppliers at home and abroad in trade on the Internet after the EU Directive on e-commerce comes into force. Some minor measures relevant to e-commerce, SMEs and venture capital were adopted. Additionally, the German government has launched a project group "Reducing Bureaucracy". In 1999 a reform of the legislation on the award of contracts had been initiated. It was concluded in February 2001 by the implementation of the new ordinance on the award of contracts (*VgV*). In addition to the revision of substantive award provisions to implement two EU directives in national law, the *VgV* contains a further improvement in the legal protection for enterprises interested in public sector contracts. On the reduction of regional differences in local electricity costs, the Monopolies Commission has reached the conclusion that the liberalisation of the German electricity market has so far been

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[65] European Commission, "Report on the Implementation of the 2000 Broad Economic Policy Guidelines, ECFIN/176/01-EN", Brussels, 2001, p. 57.

largely successful without strong regulatory pressure[66]. The German government continues to hold talks with the Energy Industry, however, in order to enhance competition in this market.

In the area of the knowledge-based economy, several measures of minor importance are trying to increase the efficiency of education and research (in particular a University Initiative for the Future, financed from the UMTS-linked interest savings). Additionally, a concept for reforming the regulations on appointments at Universities was approved. Other minor projects include projects on e-commerce and venture capital. Finally, besides the reform of the regulations on appointment at universities, the German government has tackled some minor measures related to IT issues within its programme "Innovation and Jobs in the Information Society of the 21st Century"[67]. These measures do not relate to the higher education system, however. The government has set up a federal programme for a limited period of time in addition to the present level of expenditure by the *Länder* to close investment gaps in modern IT technologies in vocational schools; it has introduced an Internet certificate for the unemployed.

The further development of the risk **capital market** is in progress. The German government stresses that gross investment by venture capital companies in Germany rose to about € 3.8 bn in 2000 and has entered a consolidation phase in 2001[68]. This trend continued in 2000 and puts the German market ahead of its European peers. Nonetheless, the area "Innovation" in Germany's new technology concept will give young technology-based firms new means of obtaining financial resources. The funds will be given in the form of participation capital or long-term loans by the Credit Agency for Reconstruction (*Kreditanstalt für Wiederaufbau*) and the *Deutsche Ausgleichsbank*. The main reform proposal that falls under the topic of the efficiency of the EU financial services market is the government's proposal to bring the supervision of banks, brokers and insurance companies together in one "All-Finance-Supervision" (*Allfinanzaufsicht*). This new institution would be financed *entirely* by the supervised banking institutions (until now, only 90% are financed privately) and its budget would become independent from the state budget. The law was adopted by cabinet but has not been voted by the Bundestag yet.

### 5.4. **Greece**

In the field of **budgetary policy**, Greece has maintained the rigour of its fiscal policy stance. The same goes for the emphasis placed on wage restraint in collective negotiations with the targets agreed upon for 2000-2001 being adhered to notwithstanding union and political pressures to revise and ease such constraints through the renegotiation of collective agreements. The general government fiscal balance has been revised downwards to between -0.6% (OECD) and -0.4% (European Commission) with the updated Stability Programme of the government expecting a deficit of 0.3% (all figures excluding UMTS-proceeds of 0.4% of GDP). Apart from the slower GDP growth (4.1 instead of 5.0% targeted in the 2000 update) and higher inflation figures for the year 2001, the government attributes this mainly to an important decline the profitability of the business sector, the continuing crisis of the Athens Stock Exchange and the loss in interest income both, of the business sector and the households. The fiscal policy stance is considered to be neutral. Alongside the issuance of large-scale convertible bonds issues in lieu of privatisation and extensive securitisation of

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66 Cf. the report "Competition Policy in Network Structures" which was presented in June 2001.

67 Cf. Bundesministerium der Finanzen, "Jahreswirtschaftsbericht", Berlin 2001, p. 49-50.

68 Cf. 4th Cardiff Report Germany, November 2001, p. 53.

future EU-funds inflows, a deep cut of defence spending was introduced in Spring 2001 so as to keep the promised budgetary targets for the year 2001.

The budget for 2002 and the stability programme update foresees a general government balance of 1.0% of GDP (which is more optimistic than the European Commission – 0.3% and the OECD – 0.6%). Doubtful aspects of the government forecasts are especially a rather optimistic growth rate (still at 3.8% as opposed to 5.2 in the 2000 update), including a timely conversion of Structural Funds and related spending to growth (and most importantly) to employment. The general government primary surplus in 2002 it projected to be 6.4%.

Privatisation efforts have been adversely affected by the Stock Market collapse in 2000-2001. The telephone company/OTE has had the majority of its share capital pass to the private sector in 2001 while the public power company/PPC has been listed at the Stock Exchange: still, the management of both stays resolutely under the Government's authority. Privatisation of shipyards goes ahead but at a slow pace; the same goes for the State-owned refineries. Privatisation efforts, nevertneless, continue: the Public Power Corporation (PPC/DEH) has been successfully introduced to the Stock Exchange, the sale of one third of the State oil company (ELLPE) goes forward (with strong interest from Russian players); OLYMPIC AIRWAYS prospects look far less successful; tourist areas/hotels of the public sector also face the consequences of the crisis. The updated stability programme indicates a substantial privatisation programme to be implemented in the year 2002.

The most disappointing initiative has been the one undertaken for Social Security reform. A special assessment of the Social Security system was prepared by the (British) Government's Actuaries. All studies undertaken indicated that both a structural impasse and a financial trap are lurking ahead. A framework for radical reform was introduced in May 2001 but was almost unanimously rejected. Now a step-by-step approach is being attempted, structured around social dialogue but with any real change deleted from the options that were initially debated. Clearly, in this are a much more progress is necessary. This field appears to be the most difficult to tackle, with local and regional elections due in 2002 and national elections for 2003.

Policy recommendations such as enhancing the flexibility of the **labour market**, stepping forward more credibly in privatisations undertaken and in overall market liberalisation and – last but by no means least – addressing the Social Security growing imbalances have been steadily in the forefront of public discourse under the overall heading of "promoting structural change". Tangible results have been moderate – and their reliability looks quite shaky as of late. Labour market flexibility has been the main goal of a late-2000 legislative reform, which was to provide for flexible arrangements in working time, part-time practices (as well as limitations in overtime so as to create new employment opportunities). This reform has been introduced by law, while the social partners were asking for time to find a negotiated settlement: this gave way to recriminations against the legislation from both employers and the labour unions, while the press joined in with further criticism. After six months in operation, the labour reforms are considered to have introduced in practice more rigidities than flexibility. Reformed labour legislation is considered as "unworkable" and "out of touch with reality", the cost burden of conforming to the new legislation is estimated at close to 8% of the overall pay package for manufacturing. Only two dozen large undertakings are considered to be able to cope with the law's requirements without sustaining competitive disadvantage.

In the field of **product markets and the knowledge-based economy**, emphasis hat been put on market liberalisation. In the energy market, this proceeds at an institutional level, but mid-2001 licenses given for private electricity production do not look set to lead to radical changes in the country's energy balance anytime up to 2004. Telecoms liberalization has proceeded at a faster pace, but five or six service providers who have started operating in early 2001 did so under unfavourable overall market conditions.

The knowledge-based economy is supposed to be the beneficiary of a large segment of Structural Funds financing (3rd Community Support Framework). To date the relevant programs do not seem to have gone ahead, however.

Privatisation efforts continue, albeit in a somewhat inconsistent manner. The Public Power Corporation (PPC/DEH) has been successfully introduced on the Stock Exchange. The sale of one third of the State oil company (ELLPE) goes forward, while prospects for the sale of OLYMPIC AIRWAYS look far less rosy. It is symptomatic that the main interest in buying OLYMPIC came from a private airline, AXON, which was forced into bankruptcy itself at the end of 2001. A different, experimental path for change is a series of merger-cum-privatisation deals, which are expected to put some dynamism back into the economy. The "mega-merger" of the State-controlled National Bank of Greece with the major private Alpha Credit Bank has been expected to bring about increased competitivity in the banking sector, but has run into difficulties of late. The same goes for mergers in the construction sector (notably the merger between market leaders Elliniki Technodomiki/AKTOR/TEB) and in electronics/technology (e.g. mergers of Intracom/Intrasoft, Altec/Sysware): initially offered tax breaks have been withdrawn for all deals that have already proceeded, thus creating uncertainties.

In the field of **capital markets**, the abrupt cutting of interest rates due to joining the Euro area has created a rapidly increasing credit demand – especially from households. Along with cutthroat competition in the banking sector, which has been through a phase of consolidation culminating in the mega-merger of the National Bank with Alpha Credit (recently facing difficulties), uncertainties have surfaced about the prudential supervision of the Banks and the credibility of their risk assessment mechanisms. Both the IMF and the Bank of Greece have been voicing concern and new supervision processes are supposed to be implemented. The question is to what extent compliance is to be expected, in the view of competitive pressures (and the rearrangement of competences in top-down consolidation cases).

## 5.5. **Spain**

In the field of **budgetary policy**, Spain has continued in its fiscal consolidation throughout 2001. Despite experiencing inflation above the EU average and weakened economic activity, Spain is likely to achieve a balanced budgetary position in the year 2001. While the central government deficit will be 0.2% higher than projected (0.5% instead of 0.3%), this difference will be fully compensated by a 0.5% surplus in the Social Security system (instead of 0.3%). Territorial governments will achieve the projected balanced budget[69].

With regard to the budget year 2002, the Spanish government is quite optimistic with regard to the key economic indicators affecting public finances. While the government has already revised most assumptions for Spain for the year 2002 downwards and, in addition, has given an alternative and more pessimistic scenario as part of the updated stability programme, most other institutions are clearly closer to the alternative scenario in their analysis. With a GDP growth of 2.4% in 2002 (as opposed to 2.0% forecast by the European Commission and the OECD), the more or less stable tax revenues projected in this assumption – based on the rise

[69] The updated Stability Programme Spain (2001, p. 18) states that the surplus of the Social Security system have allowed larger inflows to the Reserve Fund, a fact which is supposed to contribute to the medium- and long-term sustainability of the Spanish pension system.

of VAT and excise duties on some items – are essential to achieve the target of a balanced budget. Secondly, interest rates are projected to remain moderate. With regard to the long-term sustainability of public finances and despite the better than expected performance in gross debt reduction in 2001 (achieving a gross debt of 57.5% of GDP in the present programme update as opposed to 58.9% targeted in the 2000 update), the reduction in the ratio of debt to GDP now projected in the years to come will be less marked than envisaged in the previous update.

A positive achievement is the new General Law of Budgetary Stability which will, among other things, set limits on the growth of central government spending. It will lead to the preparation of a multi-annual budget projection, including annual ceilings on spending growth. The establishment of a "contingency fund", which can only be drawn on in specified cases, will also ensure that unforeseen needs can be met without altering budgetary structure or orientation[70]. In addition, a social agreement signed by the government and the social partners in 2001 should contribute to the improvement and development of the social protection system[71].

Economic policy in year 2001 has built on the crucial importance of an adequate policy to foster growth and the **labour market** with an emphasis on an adequate employment policy. Although job creation has been positive – however with a marked slowdown in the year 2001 which will be accelerated in 2002 – the amount of temporary contracts created is of high concern. This kind of jobs is not efficient in terms of productivity per worker. In addition, the level of unemployment is still the highest in EU (with an estimated 13% average in 2001) and with unsolved structural problems, not least the high regional and sectoral disparities. The labour market reform in 2001 has especially targeted a revision of legislation regulating employment contracts which should lead to a reduction of the number of fixed-term contracts while at the same time the abolition of the limit of part-time working hours should contribute to more flexibility of the labour market. On wage moderation, an agreement between the social partners in 2001 should ensure wage moderation in 2002.

Spain has continued to review policies especially in the area of regional employment services which need to be better coordinated and which should lead to stronger regional mobility of the work force. The most important problem is, however, high unemployment among women and young people. While ALMP measures have been adopted in order to increase the female employment rate, these actions are still considered to be insufficient, especially in the field of childcare for 0 to 3 years old and other dependant care. In general, Spain should improve its efforts by establishing an integrated gender mainstreaming approach. A coherent approach is also needed in the field of life-long learning, especially by adopting and implementing the new law on Vocational Training. In view of the specific recommendation on the labour market in 2000 and 2001, Spain can be said to have made progress but with the implementation of measures adopted or in process to be adopted still pending, the effects can only be assessed in due time.

With regard to the specific recommendations on **product markets and the knowledge-based economy**, the priority in Spain has been the implementation of the reform of competition law in the last two years, including the transposition of internal market legislation, the liberalisation

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[70] Cf. Spanish Stability Programme Updated, 2001, p. 23.

[71] Cf. 4th Cardiff Report Spain, December 2001, p. 40ff.

of telecommunications, the reinforcement of the competition law, the reinforcement of the competition framework in sectors such as electricity, gas and retail distribution.

With regard to ICT, Spain has advanced by the development of a regulatory framework for the ICT sectors as well as the development of the e-Administration including greater online availability of public services, the launch of an Action Plan on training measures as part of the Info XXI Initiative Action Plan and further taxation measures to foster investment in the ICT field. In general, investments in Research and Development have increased substantially in the last two years. Finally, Spain is progressing in the simplification of the regulatory framework for SMEs.

With regard to the recommendations on **capital markets**, Spain has continued to develop its capital markets. Reforms have been introduced to support business access and to facilitate investment in unlisted securities. A new Finance Law is in the legislative process which should clarify the concept of risk capital and relax some aspects of current rules which may have acted to deter their equity investment[72]. Measures will include continuing entitlements to tax benefits after the market flotation of investee companies and simpler rules for channelling investments through holding companies. Furthermore, tax treatment of risk capital funds and companies have been made more advantageous by an exemption on capital gains raised from the transfer of shares and other equity interests in investee companies under determined conditions.

### 5.6. **France**

The recent slowdown in activity, along with the coming up of general and presidential elections, exerts a significant influence on policy orientations, especially **budgetary policy**. For one thing, because of unexpected reduction in growth in 2001, tax receipts are lower and some expenditures higher than planed in the budget voted a year ago for 2001. The government has decided not to stick to its deficit target, and as a result general government deficit, excluding UMTS receipts, is targeted at 1.4% of GDP in 2001. However, real government expenditures will increase as foreseen by 1.6% in 2001. The 2000 recommendation to orient the reform of the pension system towards long-term sustainability of government finances was not met as the pension reserve fund created in 1999, expected to reach 10% of GDP in 2020 (in constant terms), will contribute to finance only a relatively small percentage of additional expenditures. Except for the reform of private pensions acted in 1993, there has thus far been no pension system reform, thereby indicating the main policy failure of the government. Although the importance of such a reform is overwhelmingly acknowledged, it is questionable that measures taken will be sufficient to avoid serious problems due to the demographic trends.

As for 2002, the voted budget is based on a rather optimistic growth forecast (over 2%), and in spite of this it foresees an increase in the deficit compared to the last fiscal year. In addition, the government has already decided to increase the amount of the *Prime pour l'emploi*, and to anticipate its payment to eligible households during the first quarter of 2002. Government expenditures in real terms are expected to grow by 1.8% in 2002, as opposed to 1.6% as recommended by the BEPGs. The government deficit would remain at 1.4% of GDP.

However, the government confirms the respect of its commitment to the multi-annual public finance programme, thus public finances should be balanced in 2004 under an assumption of

[72] Cf. 4th Cardiff Report Spain, December 2001, p. 27-29.

3% average annual growth until 2004. As for unemployment, it is still relatively high (the OFCE forecast for 2001 is 8.9% of the labour force) and would decrease to 8.4% at the end of 2002, but only thanks to an increase in subsidised jobs (*emplois-jeunes*, *contrats emploi-solidarité*) whose costs may jeopardise the implementation of public expenditures targets. Moreover, the reduction of working time also proves to be very costly for public finances, as it is accompanied by a reduction in employers' social contributions and public subsidies. In December 2001, the *Conseil constitutionnel* censored the article of the law that allowed government to finance part of this cost by not paying back its debt to social funds, even though the funds' budgets for 2001 are in surplus, thanks to the increase in employment observed over the past five years. Additional financial margins for manoeuvre will be allocated in part to reducing public deficits, and in equal part to reducing compulsory levies.

The key developments in France are currently **labour market** reforms with the 35-hours working week legislation, the improvement of incentives to work and the reduction of inactivity traps. Tax measures have been taken to increase labour supply: marginal effective tax rates on low-paid workers have been reduced. The lowest rate of personal income tax has been cut and further cuts will be implemented through until 2003. Changes have also been made to housing taxes and benefits (they have been lengthened after a household has found a job), and to eligibility requirements for health coverage (*CMU, Couverture Maladie Universelle*). From September 2001 onwards, eligible households (low-wage earners) benefit from a new tax credit scheme (*Prime pour l'emploi*) which increases the incentives to take up full time work at or just above the minimum wage.

The medium- and high-income households will benefit from the pursuit of the income tax reduction that will be implemented over 5 years (marginal tax rates will be slightly reduced), while those with low income from work will benefit from a doubling of the earned income tax credit (*Prime pour l'emploi*, from 2.2% to 4.4% of earned income, for individuals with earned income between 0.3 and one minimum wage, then decreasing up to 1.4 minimum). These two measures will again be reinforced in 2003, so that households will benefit from higher take home pay the total amount will reach € 3.1 billion at the end of 2002. These measures are supposed to favour consumption and to improve incentives to work. The rate of corporate income tax is also being progressively lowered over three years, by eliminating the Juppé sur-tax, legislated in 1996. In 2002, the legal rate, including the social contribution levied on profits, will be 35.43%. From small businesses, the rate has been further lowered, from 26.5% in 2001 to 15.45% in 2002. Altogether, the tax receipts from corporate income tax will be reduced by € 2 billion in 2002 compared to a benchmark of unchanged legislation. In addition, the planned reduction of local business tax (*Taxe professionnelle*), whose reform had started three years ago, will further reduce and eventually eliminate by 2003 the share paid on the wage bill. Firms will thus benefit from an additional reduction of € 1.33 billion in their tax bills in 2002. Finally, the business contribution levied on wage bills to finance the unemployment insurance is being reduced by 0.2 percentage points.

Little has been done to review the main income guarantee benefits. The recommendation to reform employment protection legislation with a view to better combining security with greater adaptability to facilitate access to employment, was partially implemented. Since January 2001, the French government and social partners (patronat et syndicats) adopted a "Plan d'Aide au Retour à l'Emploi" (PARE) which offers each unemployed person a *bilan de compétence*, an *aide à la formation* and job opportunities which seem relevant to their ability. After three refusals, the unemployed person loses his or her benefit allocation. The PARE is considered as an active labour market policy increasing the employability of the jobless as well as their incentives to find a job. The Emplois-Jeunes scheme, i.e. the introduction of subsidised jobs for young people created in 1997 and initially planned for a 5 year period only, has been continued.

So far, the implementation of the working time reduction law for large companies has not induced a significant increase in unit labour costs: social contributions rebates, wage moderation and hourly productivity gains were the main factors behind this. However, in 2000 and 2001, there were signs of hiring difficulties in some sectors. These could interact with the implementation of the working time reduction law in small firms from 2002, which will trigger a reduction in the hours of labour supplied. The French government decided in September 2001 to disentangle the enforcement of this working time reduction for small and medium-sized firms. Several new measures are included in the Budget Law for 2002 with regard to a reduction of labour costs[73].

With regard to the **product market and the knowledge-based economy**, the widening of the liberalisation of network industries is in progress: the liberalisation of the gas and electricity markets started in 2000 but at a slow pace. France created a new regulatory authority for the electricity sector at the beginning of 2000. Accounting separation has been achieved for the activities of Electricité de France. A further draft law (adopted in 2001) has opened the way for accounting separation for Gaz de France. In the telecommunications sector, the local loop was unbundled in early 2001. UMTS licenses were granted in mid-2001. Efforts to simplify formalities for business and to encourage innovation were continued in 2000 with measures to support cooperation in R&D between the public and private sectors, including: the setting up of seed capital funds; support for incubators; and tax incentives for investment by business angels. However, France shows a relatively low penetration rate of both Internet and mobile phones. The government adopted a wide range of measures in July 2000 to encourage the diffusion of IT throughout the population. The degree of implementation of the specific recommendations in the 2001 BEPGs is still rather limited. While no progress has been made with regard to the recommendations to step up efforts to liberalise network industries, progress made in transposing internal market directives continues. Administrative simplifications are included in the budget proposal for 2002 (e.g. scrapping of "certificat de conformité" for photocopies) and tax regimes and payment of taxes have been simplified. The share of ad hoc State aid in total has started to decrease but remains above EU average when expressed as a share of GDP.

On the **capital market**, the Commission's implementation report for 2000 rightly stated that no measures were taken to further facilitate investment by institutional investors in stock markets and in venture capital. The recommendation to give particular attention to the actions put forward in the October 1999 Risk Capital Communication, as examples of good practice to improve the taxation framework, enhance enforcement of bankruptcy legislation and to promote the further development of employee ownership schemes, can be said to have been partially implemented by: the merger between Paris, Amsterdam and Brussels exchanges to form Euronext; the creation of long term savings plans; a better protection of minority shareholders; and by the privatisation of Hervet Bank. Risk capital investment was encouraged through an extension of tax exemptions for business angels, a simplification of the tax framework for venture capital funds, and capital gains tax on the acquisition of stock options

[73] Cf. L'Observatoire Français des Conjonctures Économiques (OFCE), "French Economy Team", *Revue de l'Observatoire Français des Conjonctures Économiques (OFCE)* no. 79, October 2001; Government of the French Republic, Projet de loi de finances 2002, Paris, 2001; French National Accounts.

has been lowered to that applying to ordinary capital gains (only for modest capital gains and when shares are held for more than two years).

The recommendations in the 2001 BEPG to develop further the capital market by easing constraints on institutional investments in equities and further adapting the fiscal framework so as to facilitate investment and entrepreneurship, the latter to be also encouraged by adjusting the enforcement of bankruptcy laws have been partially tackled: Stock-savings plans (*plans d''épargne en actions*) can now include European stocks and the reduction of taxes following investment in SMEs has been extended[74].

## 5.7. **Ireland**

Ireland was the first country to be criticised by the Ecofin Council, based on art. 99 (4) TEC because Irish **budgetary policy** was adjudged to be inconsistent with the BEPGs 2000. In the recommendation the Ecofin Council noted that the Irish budget for 2001 is expansionary and pro-cyclical and therefore inconsistent with the guideline to ensure economic stability. The Irish were, therefore, asked to gear the budget for 2001 to this objective. In response, the Irish government argued that direct tax reductions were necessary as a stimulus to labour supply in the economy and to fulfil obligations under the Programme for Prosperity and Fairness (PPF), the latest Social Partnership agreement. Significant infrastructural investment in the National Development Plan and on health and education were also, it believed, necessary to ensure continued sustainable growth into the next century. The February 2001 Ecofin recommendation, as well as the BEPGs recommendation requested a correction of the 2000 overheating by fiscal tightening in 2001, as it was seen as highly unlikely that the tax reductions would increase the labour supply enough to offset the inflationary pressure, given the near or above full-employment conditions in the Irish economy and the huge wage pressure.

During 2001, Irish growth has decelerated rapidly, albeit from a very high level in 2000, due to external developments, most notably the global slowdown in demand for ICT, a sector very important for Irish exports. Measures against the spread of foot and mouth disease had negative effects on the agricultural sector and the tourism industry. The slowdown of the US economy particularly hit Ireland, as the US manufacturing sector is a major source of foreign direct investment into Ireland. As a consequence, GDP growth in Ireland in 2001 is projected at between 6.5 and 6.8%, according to the most recent forecasts. Despite a strong increase in wages, driven by labour shortages, inflation pressures have eased with the Harmonised Index of Consumer Prices (HICP) rate coming down from 5.3% in 2000 to 4.0% in 2001 and 2002 (with the Commission projecting only 3.3 in 2002). This rate is still above the average inflation and the norm in the euro zone.

The Irish government kept a tight control of expenditure, even imposing some spending cuts, and introduced tax measures that helped to ease the short-term pressures on demand. Among those measures, the special savings incentive scheme is designed to promote saving by offering tax incentives to savers The Ecofin Council, in its conclusions of 6 November 2001, noted that with these measures, "its recommendations have been to same extent adhered to".

Private consumption is estimated to have increased by about 6% in 2001 (down from 9.9 in 2000) and is expected to grow at a marginally lower rate in 2002, then more slowly in 2003 as

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[74] Cf. Projet de loi de finances 2002 (French government) and L'Observatoire Français des Conjonctures Économiques (OFCE), "French Economy Team", *Revue de l'Observatoire Français des Conjonctures Économiques (OFCE)* no. 79, October 2001.

a result of competitive pressures curbing wage increases and increased private savings. Total government expenditure is projected to increase 1% of GDP in 2002, mainly by additional spending for health services, education and science, roads and transport and housing within the framework of the National Development Plan.

Mainly as a result of the revision of growth for the next years, Ireland has abandoned the target of reaching a gross government debt ratio of less than 25% by the end of the current stability programme period. It is now expected to decline from 35.8 in 2001 to 34% in 2003, by any standards a considerable achievement, bearing in mind the level of debt in the late 1980s. With regard to the proposal of pension reform, in 1999 it was decided to initiate a policy of prefunding part of the future costs of social welfare and public service pensions by setting aside 1% of GNP annually for this purpose. The "social Welfare Reserve Fund" catered for future social welfare pension outlays, while the "Public Service Pension Fund" was targeted at future public sector pension outlays. Privatisation receipts from the flotation of semi-state enterprises will, in addition, be used to further help alleviate this particular budgetary requirement. Thus, the public finances are and remain sound.

The recommendations on **labour markets** are connected with the wider macroeconomic budgetary problems discussed above. The 2001 BEPGs recommended that *wage developments should be consistent with the maintenance of price stability*. Also, tax-benefit incentives were encouraged to facilitate a higher female participation rate in the labour force. The National Employment Action Plan 2000 contains many provisions designed to alleviate wage pressures due to the tight labour market. Yet it must be remembered that such measures are not in the overall spirit of the BEPGs recommendations, which would simply prefer fiscal contraction as a means of dampening aggregate demand, and thus reducing wage pressures. The main provisions of the National Employment Action Plan 2000 (NAP) included a preventative approach designed to stop the drift into long-term unemployment and break the path dependency that is often experienced by unemployment young people aged 25-34. To directly combat existing long-term unemployment, *Foras Áiseanna Saothair* (Education and Training Authority) increased the proportion of participants in its courses coming from the long-term unemployed, from 20% to 25% during 2000. A further € 12.7 bn will be spent through the National Development Plan upon the four "pillars" of the NAP.

Participation rates of women in the workforce have increased significantly during the past five years. The National Development Plan allocated € 317 million to the development of childcare facilities. The December 2000 budget for the 2001 fiscal year involved a further incentive for child care in Ireland, a four-week extension of maternity leave, additional spending on extra childcare support staff, and to provide for 15 civil service crèches. Complementary measures to encourage female labour market participation in increasing child benefit rates for first and second children.

Major reforms recommended in relation to the **product markets and the knowledge-based economy** amount to providing a much-needed external stimulus to reform in sectors where such competition was or still is lacking. The recommendation of trying to induce competition into "network" industries currently or previously dominated by state monopolies has proven institutionally problematic with the Irish Congress of Trade Unions, but the government seems to be overcoming such opposition. Recommendations for improved product market competition and to give greater power to the Competition Authority have proven less contentious and the Government made moves towards implementing the recommendations in these areas during 2000. New legislation giving the Competition Authority power to enforce Articles 81 and 82 of the EC Treaty is currently being planned by the *Dáil* (Lower House of the Irish Parliament). Legislation giving legal power over takeover and merger cases to the Competition Authority has been undertaken in 2001.

The presence of large state-owned or formerly state-owned incumbents in the network industries of electricity, gas, telecommunications and the health insurance market has deterred market entry and most of these markets retain dominated by a single firm market structures. However, plans to give independent regulatory agencies greater power and to enforce more rigid competition policy are gradually coming into effect. Transport market liberalisation has encountered severe political obstacles. However, several privatisations plans are underway, while the franchising of railway services and local transport in the Dublin urban area has not proceeded as planned but is being continued.

In relation to the general guideline of creating a knowledge-based society, Ireland has made some progress in relation to furthering state-sponsored human capital, R&D and ICT investment – areas in which Irish investment is below the EU average. However, Internet penetration rates in Irish homes increased from 17% to 35% between May and October 2000, and the level *and* rate of increase in Internet penetration are now well above the EU average. With improvements in local phone charges with telecommunications liberalisation, this rate of penetration should improve. The Europe action plan is slowly being implemented in all secondary schools as part of the National Development Plan, and numerous complicated subsidies and corporation tax incentives have been designed to stimulate private sector R&D further too.

**Capital market** provisions in the BEPGs in relation to seed and venture capital have propelled the Government into a number of regulatory and market reforms in the area. In February 2001, the Irish Financial Services Regulatory Authority was established with an remit to control consumer interests in the banking and insurance markets. The Central Bank of Ireland was also assigned responsibility to regulate insurance and investment intermediaries. Though there is a fear of increased market distortions and bureaucracy from such actions, the regulation is seen as necessary to maintain consumer confidence in the banking and insurance markets. Privatisation of the Trustee Savings Bank and the Industrial Credit Corporation has been proceeding, but delayed by fears of an inappropriate flotation price as occurred with the flotation of Telecom Éireann in 1999. The move to trade Government bonds and gilts in the euro clear market in the wake of EMU, while effectively meaning the disappearance of the Irish bond market, will provide a deeper risk and liquidity pool in which to trade such instruments. The purchase of the Xetra trading system from the *Deutsche Börse* will also facilitate greater volume trading of equities on the Irish Stock Exchange.

### 5.8. **Italy**

With regard to **budgetary policy**, Italy will not meet the target of a general government deficit of 0.8% as projected in the last stability programme update and thus fails to meet the recommendations both of the Ecofin opinion on the programme update and of the BEPGs 2001. While the government, in its new programme update, expects a deficit of 1.1% of GDP, the Commission Autumn forecast (1.2%) and the OECD (1.4%) are less optimistic. In the light of the economic slowdown, the Italian government introduced several measures in July 2001 to contain public expenditure for goods and services, to reduce reimbursements for drug prescriptions, to accelerate sales of real estate assets and to support investments. In addition, tax revenues produced an unexpected windfall. With these measures, Italy was able to prevent a further deterioration of the general government deficit in 2001 and total expenditure is believed to stay at 47.2% of GDP, as projected in the 2000 programme update.

The stability programme update, which was concluded in October 2001, projects that the general government deficit target of 0.5% in 2002 can be achieved, even though GDP growth projections have been reduced by 0.8% to 2.3% in 2002. As one of the measures taken by the government, tax reductions included in the budget of 2001 have been postponed and an acceleration of additional asset sales is planned. As the Commission Autumn forecast as well as the OECD indicate some of the assumptions of the government for the year 2002 might be over optimistic. This concerns, in particular, the revenue created by the sale of publicly-owned real-estate, where reliable information on the scope of these properties does not exists, as well as the projected effects of the measures to encourage the surfacing of the underground economy. Thus, projections of the Commission, the OECD and the IMF expect the deficit above 1% of GDP. Furthermore, the updated stability programme keeps the commitment to achieve a balanced budget by the year 2003, based on a primary surplus of above 6% of GDP. However prospects for the implementation of this goal are again subject to great uncertainty.

The reduction of the gross government debt ratio throughout the stability programme period have been revised downwards with a new target of 98% of GDP in 2004. Structural reforms, especially on public expenditure, are slowly underway within the programme for the government's terms in office. In addition, new agreements on the health sector within the framework of Italy internal stability pact have been concluded which, on the one hand, will shift the responsibility of regional expenditure overruns to the regions themselves, i.e. they will have to be covered from their own resources, and on the other hand, regions will have greater autonomy with regard to the control of expenditure and the limiting of demand. The implementation of the pact and its amendments will, however, be crucial for the control of public finances. In the field of pension reform, another important recommendation in the BEPGs, a report from the Brambilla Commission is currently being discussed which contains several reform options; but real progress has been very modest so far and put, at risk the government's medium-term expenditure and taxation plans.

With regard to the **labour market**, employment has continued to rise, continuing the trend of the year 2000. The unemployment rate is going to be reduced by 1 to 9.5% according to the Commission Autumn forecast, i.e. above the EU average, before it is rises moderately in 2002 with employment growth decelerating more substantially. Regional disparities remain strong, however. Public expenditure and fiscal incentives to investment and to new hiring continue to focus on the southern region of the country. The recommendations on the BEPG on the labour market in Italy especially concern the reduction of the tax burden on labour. Some incentive measures were included in the 2001 budget law which have led to a rise in permanent full-time contracts. Measures taken in the second part of the year 2001 were, among others, the transposition of the European directive on fixed-term contracts, new fiscal and social contribution incentives to combat the hidden economy, as well as the introduction of the possibility of tax rebate for education and training expenditure. Furthermore, a reduction of social security contributions is planned in order to give an incentive for companies as well as workers and thus to increase the employment rate. As the European joint employment report notes, however, structural reforms of the labour market continue to be postponed and others continue at a slow pace. Thus, the more far-reaching BEPGs recommendations cannot be considered as being implemented fully.

In Autumn 2001, the government presented a white book on employment and social issues which aims at improving the employment performance. The white book particularly focuses on increasing the employment of young people, women and older people. Measures should facilitate the use of part-time contracts and thus also contribute to a better market entry of young people and women, the simplification of regulations for private job-market services, and the use of ICT in the labour information system. Proposed measures should also address the problem of wage developments not taking into account productivity and regional labour market differentials. The proposals of the new government are thus very much in line with the BEPGs recommendations of 2001. However, implementation will only commence later in the year.

With regard to **product markets and the knowledge-based economy**, Italy has made progress with regard to the liberalisation of key network industries, for example in the energy sector where the demand side of the market has been further liberalised. More competitive pricing has been introduced in the gas sector, the unbundling of the local telephone loop has progressed, as well as the introduction of new powers for the Antitrust Authority. Regulations, however, have to be streamlined, and the implementation of measures has to be accelerated at the local level.

In regard to promotion of the business sector's involvement in Research and Development, and to the encouragement of the wider diffusion of ICT and the use of e-commerce, Italy remains below the EU average despite having increased its commitment in recent years. In order to increase the effectiveness of the measures taken, local administrative capacity and law enforcement especially needs to be improved. This is even more important in the South, which is lagging behind considerably in the field of innovation. The implementation of the Tremonti Law should be completed by the end of the year 2002. It includes incentives for investment decisions, simplifies procedures and encompass a wide range of eligible beneficiaries. A business taxation reform, which should reduce corporate income taxation to 33% and simplifation of procedures is planned.

On the BEPGs recommendation for **capital markets**, no real progress can be noted so far with regard to the adjustment of bankruptcy laws, although a proposal has been submitted to Parliament. Venture capital investment decreased in 2001, as in most other Member States. This is still below the EU average but remains firmly above 1999-levels. Positive effects are expected from the continuation of the privatisation programme of the government in 2002, while regulatory reforms have also been pursued further.

### 5.9. **Luxembourg**

The present general slow-down in economic growth does not endanger the successful execution of Luxembourg **budgetary policy**. Despite a new round of tax cuts and revenue loss due to the growth slowdown, a general government surplus of 4.1 and of 2.8% of GDP in, respectively, 2001 and 2002 is expected by the government according to the updated stability programme. In 2003, the surplus should increase again. The forecast of a 3.9% GDP growth in 2001 and of 5.3% in 2002, followed by an upswing, are reassuring[75]. A potential weakness of the Luxembourg economy is the still limited number of sectors on which growth depends and their unequal contribution towards it. In other words, Luxembourg's growth performance is largely determined by a small number of sectors among which the financial sector stands out. Luxembourg's general government expenditure continued to grow (40.3% of GDP as opposed to 39.8% projected in the stability programme update of December 2000), but public revenue increased even faster (44.4% as opposed to 42.6%). Wage inflation accelerated during the first half of 2001, mainly due to the fact that a wage indexation tranche fell due in April 2001. HICP is projected to rise by 2.6% in 2001, with underlying inflation having increased even further, and by 2.2% in 2002 according to the Commission Autumn

[75] The Commission in its Autumn forecast projects a GDP growth in 2002 of 3.0%.

forecast. This will support wage moderation in the next two years, even though a new wage indexation tranche is likely to fall due during the second half of 2002.

Despite the lower growth rates in 2001 and 2002, the Government intends to proceed, as decided in 2000, with the ongoing reductions in income taxes. A first reduction took place in 2001 and is to be followed by a 0.9% reduction in 2002. Corporate tax should also be reduced in 2002 by approximately 1.5% of GDP.

During the year 2001, Luxembourg made further progress with regard to pension systems and the long-term sustainability of the Luxembourg pension scheme. A round table (*Rentendësch*), including the social partners, adopted a package of measures to the benefit of pensioners under the private sector pension scheme, which will come into effect as of March 2002[76].

With regard to the **labour market**, one challenge for Luxembourg is to increase the national employment rate and to mobilise the "reservoir" of national labour supply in view of looming skill shortages and increasing wage levels. Early retirement, pre-retirement and disability pension schemes have encouraged many to withdraw early from the labour market. Mobilising measures to counteract that effect are being taken e.g. the introduction of parental leave with a guarantee of re-employment and (1999) targeted activation programmes. In June 2001, the social partners agreed on proposals of the government to promote active ageing by restricting access to occupational invalidity and by keeping older workers in employment. Some measures were taken for the integration of the disabled and for people most excluded from the labour market. A "service for workers with reduced capacity" within the employment service is planned. Employers and local authorities are supported to promote women's access or return to employment by providing day care facilities for children and dependent persons.

The tax reform which was introduced in 2001 will also encourage employment through a significant reduction of labour taxation by increasing the non-taxable minimum income. The taxation on income brackets has been reduced and will be further reduced in 2002. Furthermore, the Government plans to reduce the tax burden on businesses to 30% in 2002. Employment growth is forecast at 5.4% in 2001 and at 2.3% in 2002 while unemployment is expected to rise moderately from 2.2 to 2.4 and returning to the 2001 level in 2003.

In the year 2000, in accordance with the BEPG Recommendations on **product markets and the knowledge-based economy**, the transposition deficit of the internal market legislation has been significantly reduced and a body for assessing progress has been set up. The relatively small size of Luxembourg's civil service seems to be a major reason behind some of the delay in transposing Community directives. Regional aids have also been reduced. But price regulation in some sectors and the lack of power of the competition authority continue to limit the degree of competition in the product markets. However, a change in the law on prices, competition and consumer protection is being prepared, which is to be seen in conjunction with the move towards a more decentralized European Competition policy. Thus, the 2001 recommendation on the implementation of the announced abolition of fixed and monitored prices and the establishment of a new independent competition authority with the powers to investigate and to sanction is being taken into account.

With regard to the knowledge-based economy, Luxembourg continues to implement the "Luxembourg" Programme with a special focus on e-government, education and research, organisation of work, and electronic commerce. Furthermore, the government is sticking to its commitment to increase the budgetary support for R&D to 0.3% of GDP by 2004.

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[76] Updated stability programme Luxembourg, November 2001, p. 21f.

With respect to the **capital market**, Luxembourg was not given any recommendation in 2001. In view of extending the reach of the Luxembourg stock exchange, a cross-border agreement has linked the Luxembourg exchange to Euronext (merger of the French, Dutch and Belgian stock markets). This agreement has to be seen as another step towards the creation of a world-wide integrated stock market. The market share of the Luxembourg stock exchange of all international bonds quoted on European stock markets is 65%. As a result of the increased activity rate of the Luxembourg financial market in 2000, the number of workers employed in the banking sector has increased by 1.451, i.e. an increase of 7.1% compared to a 5.6% increase for the economy as a whole. The recent law on electronic commerce should stimulate e-banking even further. Nevertheless, the banking sector was hit by the financial turmoil in 2001.

### 5.10. **Netherlands**

With regard to **budgetary policy**, the Netherlands will be able to achieve the general government balance target set in the 2000 stability programme update of 0.7 - 1.0% of GDP, despite lower than projected GDP growth (which according to the 2001 programme update, will be 2.0% instead of 4.0% with more recent figures being less optimistic)[77]. The reduction of general government gross debt has been a major achievement. It will even surpass the targets going down to 51.8% of GDP and thus firmly below 60%. Thus, budgetary policy and results have been in line with the recommendations, even though inflation was well above the EU average, mainly as a result of the increase of value added tax and higher food prices. The problem of overheating has disappeared since the economic slowdown.

The 2002 budget is continuing the macro-economic policy stance of previous years, thus projecting budgetary surpluses not only in 2002 but in the coming years, too. On top of the extra public spending of EUR 4.4 billion laid down in the coalition agreement and the extra spending increases in previous years, the government has found room within the spending limits for an additional injection of € 3.8 billion in 2002. While achieving a large reduction of government debt, additional expenditure in 2002 is mainly targeted at care, education and safety. Much of the extra spending in these priority social sectors will be used to improve substantially employment conditions in the public sector. The extra money available is partly the result of lower expenditure, e.g. on interest and social security, due to the sharp reduction in government debt and lower interest rates, and the fact that unemployment was lower than was assumed in the coalition agreement. The increases in expenditure are subject to the spending limits for the central government budget in the narrow sense (excluding care and social security), the social security and labour market sector, and the care sector. A less substantial tax cut than the radical reform in 2001 is planned for 2002, targeted at specific groups. The main objectives are to encourage job-seekers, especially people re-entering the labour market, and to tackle the poverty trap. Revenue in 2002 from taxes, social insurance contributions and natural gas is expected to exceed the benchmarks based on the coalition agreement that were presented in the 1999 Budget Memorandum. According to the stability programme update, the government is going to use approximately 75% of the revenue windfall during its term in office for debt reduction while the remainder is used for additional tax cuts. With this, the coalition agreement specifying that revenue windfalls should be allocated equally

[77] More recent forecasts are projecting a lower GPD growth, i.e. the Commission Autumn forecasts expects 1.5.% while the OECD expects 1.3%. The 2001 programme update of the government was submitted in mid-October 2001. The general government surplus in 2001 is now projected to be slightly lower than the figures given in the programme update, i.e. at 0.7% of GPD.

to debt reduction and tax cuts has been amended, and is in line with the BEPG and stability programme recommendations on securing the long-term sustainability of public finances in view of the ageing population and on containing inflationary pressures.

**Labour market** reforms, including sustained wage moderation, reduction of minimum wages for young employees, the dynamic development of temporary employment agencies, and the growth of part-time jobs, have increased labour flexibility. Consequently, the labour supply has increased considerably and the employment rate has sharply risen, while unemployment has been substantially reduced in recent years. Nevertheless, due to the less favourable economic outlook for the year 2002, unemployment will rise again in 2002. This could lead to a slowing down of wage increases, though remaining rather strong as collective labour agreements for 2002 are already underway.

With regard to the recommendations on labour markets, various initiatives have been taken to alleviate the poverty trap. The tax reform of 2001, with its focus on the poverty trap and on reducing disincentives in the benefit system, cannot be fully assessed at the moment. In 2002 several measures will be taken to increase the labour supply, especially of older people and people without jobs. Progress to reduce the high number of persons outside the labour market supported by passive income support schemes has been disappointing. The government and social partners are still pondering ways and means of reforming the disability pension scheme – as recommending by the Donner Commission – in order to stem the growing number of people with an invalidity benefit and to promote a reintegration of those already receiving benefit. Proposals include disability benefits only to people who are 100% incapacitated, while the partially disabled will be encouraged to find suitable jobs that fits their capabilities.

With regard to the **product markets and the knowledge-based economy**, the efficiency of product markets is on the whole satisfactory. Moreover, competition policy is now more pro-active than it was before. With regard to further progress in enforcing the public procurement directives, the government has taken action to improve the awareness of procurement rules and to facilitate the correct application of those rules. More measures are still in progress.

As regards ICT and the knowledge-based economy many policy papers have been published and many policy initiatives have been taken, e.g. the establishment of a Task Force ICT and Knowledge which aims at strengthening the cooperation between the public and the private sector, including improved synergy between private business and research institutes. It is particularly focused on wireless technology, embedded systems, software engineering and multimedia. It will also will offer a market-place for ICT knowledge, supported by a special website on Internet. Another example is the provision of subsidies for innovative pilot projects in the field of R&D aimed at technological breakthroughs, which are useful for a multitude of applications throughout the economy. In order to increase the supply of ICT personnel and trained researchers an "ICTpuntonline" has been established in order to match supply and demand in the labour market by disseminating information and ideas amongst IT managers, personnel managers, trainers, teachers, student counsellors etc.

The privatisation of the railways has produced disappointing results so far, especially as regards the punctuality of transport services. While the liberalisation of the cable market is not yet in sight within the next two years, the liberalisation of gas and electricity markets is progressing on schedule, for – progressively – big, medium and small users. The management of gas and electricity infrastructure has been entrusted to a separate legal entity, ensuring non-discriminatory access. A separate body, which is part of the National Competition Authority, is responsible for supervising the technical agreements on the security of supply as well as the network and supply tariffs.

More generally, there is still ample room for the improvement of the functioning of markets. Various public initiatives have been taken to foster a knowledge-based society, but the process seems mainly market-driven.

**Capital markets** in the Netherlands function smoothly. The Netherlands has a very strong financial sector. Even the market for venture capital is well-developed. A Bankruptcy Act Amendment Bill relating to the promotion of the effectiveness of the moratorium and winding up procedures has been submitted to the Second Chamber of Parliament.

### 5.11. **Austria**

With regard to **budgetary policy**, the Austrian stability programme update of November 2001 forecasts that Austria will already have achieved a balanced budget in the year 2001[78]. The main contributors to this better than expected performance were savings made in interest payments, administrative reforms and lower than budgeted expenditure on employees. These improved the expenditure side, while the development of tax payments (income and corporate tax) helped to increase the revenue side of the budget. The public debt ratio in 2001, however, turned out 0.4 worse than expected (at 61.8%) although the plan to attain the 60% ratio in 2002has been maintained. All in all, this positive result was achieved despite a much lower real GDP growth in 2001 (1.3% down from 2.8% as projected in the 2000 update) and at the expense of rising unemployment and a decrease of households' purchasing power.

The supreme goal of the current government is to achieve a balanced budget by 2002, or rather to maintain it. It is to be achieved on the expenditure side by a pension reform and reduced civil service payroll, on the revenue side by a number of increased or newly introduced taxes and public charges. These fiscal measures are expected to have a dampening impact on household net incomes. A reduction in the number of public employees is expected with the introduction of annualised working-time models in the public service from 1 January 2002 resulting in savings in overtime payments. Discretionary (i.e. non-mandatory) expenditure in the public sector is to be cut as a result of a variety of measures. A policy of wage moderation in the public sector from 2001 to 2003 will also have the effect of curbing spending. For 2002, a percentage increase of 0.8% was agreed. Government transfer payments are to be concentrated on core functions, *inter alia* by continuing on the course of making certain areas into independent companies. Federal payments to all hived-off areas are also to be limited.

On the revenue side a series of measures in the field of taxes and public charges is projected to increase government income by 1% of GDP. Further privatisations will also contribute to the revenues. Another important element of the government strategy to achieve a balanced budget is the new burden-sharing arrangement with the states and the municipalities. However, some measures are planned that will increase expenditure or reduce revenues. These measures include: special programmes for disabled persons; the new family allowance introduced by 2002; increased R&D Funds; and reduction of non-wage labour costs. The new childcare allowance (*Kindergeld*) will enter into force on 1 January 2002. The new childcare allowance will be paid to every parent staying at home or only working part-time (earning less than € 14,535 a year) for up to three years (when both parents divide parental leave between them). Benefit levels have increased sightly.

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[78] Note that both the Commission Autumn Forecast as well as the Austrian National Bank predict a deficit of 0.2% of GDP, which however will be better than 2000 stability programme target of 0.7%.

It remains to be seen if the implementation of several of these measures will have the intended effects. The budgetary consolidation in any case will have some consequences for other policy sectors covered by the BEPGs, e.g. employment policies. At the same time, further reforms of the pension system are still only in the planning stage despite the recommendation in the 2001 BEPGs.

As regard recommendations for the **labour market**, Austria was most notably asked to increase incentives for older workers to remain active in the labour market. The major pension reform, which became effective on 1 October 2001, includes several incentives to raise the relatively low retirement age in Austria and a gradual increase in the early retirement age by a total of 18 months (to 56.5 for women and 61.5 for men), a penalty/reward system for taking or postponing early retirement and the abolition of early retirement due to reduced ability to work. Another important element of this reform is the reduction of survivors' pensions in cases where there is an entitlement to a private pension. To support the development of the third pillar of the pension system the tax benefit for private retirement provision will be increased.

Under the heading of "social targeting" the government implemented several measures to enhance the incentives of the unemployment insurance system to take up work. The maximum replacement rate was reduced, and the conditions of eligibility for unemployment benefits were tightened. A package of measures for older workers entered into force on 1 October 2000. It included a bonus/malus system for employers' contributions to the unemployment insurance scheme when they hire or fire workers over 50 years of age.

Also with regard to the general recommendations, several reforms introduced relate to the guidelines. A change in social security legislation entered into force on 1 January 2001. Non-working spouses (without children and other dependent persons to look after) of employed persons no longer have free access to health insurance. This measure was intended to increase the revenues of the social security institutions (in the context of achieving a balanced federal budget by 2002) as well as to encourage participation in the labour market. The first reports of the social security institutions indicate, however, that the first goal will not be achieved because of the considerable administrative cost of identifying the persons that are now obliged to insure themselves.

Country-specific recommendations on **product markets** were implemented during the years 2000 and 2001. The energy markets liberalisation act passed parliament in July 2000. This act fully liberalises the electricity and gas markets. The original electricity market liberalisation act of the former government intended a liberalisation in three steps up to 19 February 2003. This timetable was in accordance with EC Directive 96/92 and would have opened the market to a degree of about 36% (for consumers with a consumption exceeding 9 GWh per year). The new government decided to liberalise the market completely by October 2002. A new electricity regulation authority is competent to supervise the market. A similar development took place in the natural gas market. The partial liberalisation in accordance with EC Directive 98/30 was replaced by full liberalisation by October 2002.

The relatively low R&D quota of 1.8% of GDP is to be increased to 2% by 2002 and 2.5% by 2005. For the current legislative period the government has earmarked a special fund of € 0.5 billion for its "technological offensive". As institutional innovation, a Research and Technology Council was set up that is responsible for the distribution of the special funds. The Council developed a strategy paper in order to help the government to achieve its ambitious goal of a R&D quota of 2.5% by 2005. In addition, businesses will be encouraged to spend more on R&D. The tax reform 2000 provides for an increase of the research allowance.

In March 2001, the National Council adopted a law that will create a federal public procurement agency. Public procurement, which is now in the responsibility of the individual ministries, will thereby be centralised and streamlined. The government expects savings of about € 41.4 million per year. Further policies with regard to the general recommendations were taken in the field of competition policy and on privatisation. Since the year 2000 the Cartel Court has been empowered to launch cartel proceedings at its own discretion. In June 2001 the government presented its plans to install an independent competition authority and to appoint a federal attorney to supervise competition. In April 2001, the Broadcasting and Telekom Control GmbH *(Rundfunk und Telekom Regulierungsbehörde*) was created. This authority combines regulatory and supervisory competencies in the fields of telecommunication and electronic media. With an amendment to the Penal Code in May 2000 the elements of bankruptcy were redefined in order to decriminalise entrepreneurship and to give entrepreneurs a second chance. Finally, the Austrian Industrial Holding Corp. (ÖIAG) privatised several state-owned enterprises. Privatisation included the Postal Savings Bank, more than 17% of the Vienna Airport AG, the State Printing Office and Telekom Austria AG. These privatisations reduced the liabilities of the ÖIAG from € 6.26 billion to € 2.73 billion.

Several measures were taken to strengthen the Austrian **capital market**. These measures included the abolition of the stock exchange turnover tax, tax benefits for stock options under certain conditions, the abolition of the inheritance tax for the acquisition of holdings of less than 1% of shares in public limited companies by way of succession and a tax allowance of € 726.70 for the issue of employee shares is raised to € 1,453.50.

An expert team on Bank supervision examined the possibility and perspective of a reform of the banking supervisory authority and presented its final report at the end of 2000. In July 2001 the National Council adopted a law that will implement a financial markets supervisory authority which is to supervise all financial institutions. This authority, that shall be operative by April 2002, will replace several authorities that supervised different kinds of financial institutions.

### 5.12. **Portugal**

In **budgetary policy**, according to the latest forecasts, the overall governmental deficit for 2001 is estimated at 2.2% of GDP. The higher deficit is mainly due to a shortfall in tax revenue, resulting from a considerably less favourable performance of both domestic and international economies. GDP growth projections for 2001 had to be revised to 2.0% and 1.75 in 2002 in the updated stability programme. The Commission in its Autumn forecasts was less optimistic (1.7 and 1.5 respectively). In general, a decrease in domestic demand and the international background will mainly contribute to this negative development in 2002. As a consequence, however, inflation which had picked up substantially in 2001 will decelerate in 2002 to 2.8%.

With regard to the recommendation to rectify government expenditure in case of lower than projected revenue in 2001, the government implemented a budget revision in June which is likely to reduce total expenditure by 0.6% compared to the 2000 stability programme update. The rectifying budget aimed mainly at lowering current expenditure, i.e. to compensate for the estimated tax revenue shortfall, further tax measures to stimulate saving and investment; and a regularisation of the financial situation of the National Health Service and other measures to support the reform of the system.

In the light of the economic downturn, Portugal aims at keeping its pace in the reduction of the deficit ratio of the budget during 2002 and 2003 and hopes to compensate for the strong revision of the general government deficit in 2001 only in 2004 in order to meet the medium-term target of a balanced budget. With its new programme update, the government neither fulfils the aims of the last update, nor the recommendations in the Ecofin opinion on its update and in the BEPGs 2001. During 2001, the gross debt level actually deteriorated (from 53.7 to 55.9% of GDP) and is expected to be reduced at a much slower pace than projected in the last programme update in 2000.

Portugal made some progress in the area of the health care system in order to improve expenditure control and efficiency and to strengthen the financial position of the social security sector. Some measures have already been taken, especially with regard to the improvement of financial control, while others are still in the planning stage[79]. The implementation of the Public Expenditure Reform Programme for the period 2002/2004 should further increase the efficiency and quality of expenditure, the development of a more active tax policy, and an acceleration of tax reliefs on labour and capital as a means of stimulating aggregate supply. With this, private consumption and economic growth should be sustained. In addition, the programme should help to restructure the state corporate sector and thus lower the heavy burden it represents to public finances. Finally, a new Budgetary Framework Law defines the general and horizontal rules for the budget and accounts of the General Government, as well as the rules and procedures related to the State Budget and the State accounts, including the Social Security Sub-sector. It should support the control of expenditure and aims at multi-annual financial programming.

In spite of positive developments in the **labour market** policy of Portugal, structural problems remain, such as low levels of education and qualifications within the workforce (especially among the older workers), low productivity levels and a largely undeveloped service sector. The slow progress on these matters may create difficulties for convergence towards the average development levels of the European Union. According to the Commission Autumn forecast, employment growth is likely to decrease to 0.7% in 2002 after 1.5% in 2001. While unemployment will only moderately decrease in 2001 it will rise in 2002 (to 4.3%) and 2003, which will however still be substantially below the EU average. Wage moderation will thus be maintained in the next two years, both in the private and public sector, not least by the projected deceleration in inflation.

The 2001 National Employment Plan foresees measures to improve the qualification of human resources by permanent training measures, programmes of education and training of adults, training for currently employed workers and specific training for the short and long-term unemployed. Furthermore, Portugal aims at combating labour market mismatches and at the same time steps up social protection and reducing poverty policies. In February 2001, the Economic and Social Council agreed on specific measures to improve job conditions, hygiene and safety, hazard prevention, employment policy, labour market conditions, education and training (the agreements on "Employment policy, labour market, education and training" and on "Working conditions, occupational wealth and safety and combating occupational accidents"). Labour market regulations were amended to combat non-registered employment. The monitoring of situations of fixed-term contracting proceeded by an intensification of inspections and further incentives for employers to change fixed-term contracts into permanent contracts. Furthermore, measures aiming to reduce early school leaving, a double certification scheme and increases in vocational courses are planned, while a comprehensive lifelong

[79] Cf. Stability Programme update Portugal, December 2001, p. 15f.

learning strategy has been developed but needs to be implemented in the light of ambitious targets.

The 2001 Cardiff report of the Portuguese government presents an overview on the developments in the area of **product markets and knowledge-based economy**. Most notably, the Third Community Support Framework is now in the process of being implemented, focussing on the improvement of structural problems such as the promotion of competitiveness of companies, the modernisation of SME and the spreading of new technology. Enhanced efforts have been made with regard to R&D investment, most notably via the new Integrated Program for the Support to Innovation, the reinforcement of advanced training of human resources in Science and Technology as well as initiatives to encourage the co-operation between entrepreneurs and R&D systems and a new R&D program consisting of a joint venture between corporations and research institutions. Furthermore, the regime of tax incentives for corporate R&D has been revised. In the ICT sector, the certification of skills as well as training efforts have been improved.

With regard to the recommendation for further liberalisation in the energy sector, the directives concerning the common rules for the liberalisation of the natural gas market and the constitution and maintenance of security reserves of oil products were transposed in January 2001. The liberalisation of the electricity market is in process (by revising the respective regulations). Associated transport and distribution network average tariffs in the electricity energy sector could be reduced by further liberalisation efforts. Finally, a better transposition of community legislation can be noted (down to 2.5%, EU-average in November 2001: 2.0%), a trend which has been continued in recent years.

The Cardiff report notes that development of the risk **capital market** has been stimulated through the inclusion, in the context of the Community Support Framework, of credit lines specifically tailored for this kind of investment. Venture capital institutions can deduct 100% of the profits from the companies in which they take shares, following a revision of the tax allowance statute. Furthermore, some other tax related measures were taken. On the recommendation regarding bankruptcy legislation, that is, the adjustment of the legislation on winding-up and liquidations to the needs of economic, social and forensic legal systems, a legislative proposal has not yet been submitted[80].

## 5.13. **Finland**

With regard to **budgetary policy** in Finland, despite the substantial revision of GDP growth targets in 2001 (while the 2000 stability programme update projected a 4.2% growth, latest figures expect only a small growth of 0.5 to 0.6%), Finland seems to secure the projected general government financial balance of 4.7% of GDP. Nevertheless, both government expenditure and revenue increased substantially compared to the targets set in the stability programme update. In addition, the employment situation points to persistent structural problems in the labour market and Finland's heavy reliance on one sector, the telecommunications, as basis for economic growth has had a very negative impact on economic performance in 2001.

With regard to the year 2002, the overall view of future economic development of the country is less optimistic than before. With global economic growth prospects for 2002 bleak, the Finnish government has cut growth prospects by half and estimates GDP growth at 1.6% in

[80] Cf. 4$^{th}$ Cardiff Report Portugal, November 2001.

2002. The period of falling exports is expected to be over, however. The update assumes that the growth in domestic demand will range around 2% and total output is anticipated to grow about 1.5%. Employment will cease to grow and unemployment is expected to slightly rise. The average employment rate is forecast at 67.5% of the working age population and the unemployment rate at 9.5 of the labour force[81].

The update for 2001 assumes that the surplus in central government finances in 2001 will correspond to 1.9% of GDP (with the general government balance at 2.6% of GDP). This marks a remarkable drop from the 2000 surplus of 3.5% of GDP and is mainly due to the business cycle. In 2002 the central government's total revenue is estimated to hold steady at the current year's level. Total corporate tax revenue will fall further, but the increase in the central government's share of revenue compared with the municipalities will offset this from the stand-point of central government tax revenue. The government will pursue its policy of tax reductions as implied in the BEPGs despite of the decreasing performance of the economy[82]. The budget proposal for 2002 includes tax cuts amounting to € 665 million (0.5% of total output), which was agreed in the collective bargaining negotiations in November 2000. The central government's share of the tax cuts is 70%. Finally, the reduction of general government gross debt is expected to come to a standstill in 2002 and 2003 with a light increase of 0.3% over the two years, but should gradually continue in 2004. The main reason for this change of forecast can be attributed to the lower surplus and the changed investment policy of the pensions insurance companies.

The Finnish **labour market** situation is one of the greatest concerns for the country. Despite the high rate of economic growth that has been achieved in recent years the level of unemployment has remained at a relatively high level. Unemployment has come down from crisis levels more rapidly than in other countries, but unemployment remains in the early 2000's as the main economic problem of Finland. The Ministry of Finance predicted that unemployment would remain at the level of 9% for the years 2000-2001. This would mean that the employment rate would remain at the level of 67.5% for the year 2002[83]. Employment has gone up and the present rate already exceeds the EU average. The explanation is that Finnish unemployment is of a structural nature. The growth of the demand for labour has taken place in high technology sectors and does not offer employment for an ageing population and often inadequately trained surplus labour.The Finnish labour market is, in consequence not in equilibrium. Other serious problems include a high benefit dependency among the working-age population, high taxation on labour and a compressed wage distribution. Furthermore, there are labour bottlenecks in certain regions and sectors while other regions experience severe structural problems manifested in disproportionately high unemployment rates among low-skilled and older workers. Progress has, however, been sluggish.

The Council recommendations both for the year 2000 and 2001 pointed to the need to improve the functioning of the labour market through reforms in policies that enhance incentives for the labour reserves to enter the employment market. Reducing the high level of taxation was seen as one of the key instruments. In a similar way also the reform of the pension system was seen as an instrument, no doubt the improvement of the employment

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81 Updated Stability Programme for Finland, November 2001, Ministry of Finance, Economics Department, *Economic Survey*, September 2001, p. 4.

82 Ministry of Finance, Economics Department, *Economic Survey*, September 2001, p. 10.

83 ibid.

situation is the key issue for the Finnish government in its economic policy. The present government, nominated in spring 1999, has set the improvement of employment as its main objective. Employment policy measures are part of the incomes policy arrangement and therefore subject to wider economic policy arrangements. As a response to the recommendations, the Finnish government in 2000 initiated preparations to reform the employment and unemployment pensions schemes. The preparation of the reform takes place in a tripartite process including government, employers and workers. Legislative measures are due to be outlined in 2002. Key proposals in the employment promotion issues imply first of all the rise of the eligibility age limit for the "additional daily allowance" after 500 days of unemployment from 57 years to 59 years. Also an eligibility condition of 5 years of work history in the past 15 years will be applied. Daily unemployment allowances would be granted until the age of 65 and changes related to the "additional daily allowances" would replace the current system of unemployment pension. Measures proposed aim at keeping employees actively in working life for a longer period than currently and thus provide a solution to future shortages of labour. Within the National Action Plan adopted in spring 2001, the key policy instrument is education policy. A report on education policy is to be given to Parliament in 2002.

In the field of **product markets and the knowledge-based economy**, Finland has made very positive progress in the transition to a knowledge-based economy and in the functioning of the market system in product markets in recent years. Finland is an open economy and stands high in the process of introducing the internal market legislation. The response of the government to market reforms indicated in recommendations on public procurement at the local level and increase competition in specific sectors such as distribution, construction and the media sector, has been positive. A key economic policy goal of the government is to safeguard the preconditions for sustainable economic growth by implementing structural reforms on the product, capital and labour markets. The November 2001 update of the stability programme points to measures in industrial policy focus. Key areas of interest comprise measures to boost the competition environment and market access as well as the promotion of entrepreneurship. The update stresses that efforts have been made to reduce the amount of sector-specific business subsidies and to replace them with the development of the operating environment of business and intangible investments. The system of business subsidies has been made simpler, supervision of aid has been boosted and measures have been taken to better evaluate the impact of subsidies.

In the field of **capital markets** the recommendations for both years noted with satisfaction the progress made. The Finnish capital market has experienced a rapid and very dynamic growth since the mid-1990's. The deepening of the capital market goes hand in hand with the expansion of the Finnish economy. The 2001 Cardiff report of the government states that new rules and regulations on insider trading based on a self-regulatory regime of the markets have been drafted and that the securities settlement system and service chain have been strengthened. During 2001, further reforms are underway on the financial markets, including measures to enhance the infrastructure of the stock markets and developments in the regulatory regime of financial conglomerates and in the operating environment of companies offering financial services. Finally, the right of non-financial companies to accept deposit funds and the competition environment of the statutory earnings-related pension scheme, are in the process of being reformed[84].

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[84] Cf. 4th Cardiff Report Finland, November 2001, p. 21.

## 5.14. **Sweden**

With regard to **budgetary policy**, the Swedish economy and public finances are, in the opinion of the government, well-prepared to face the global economic slowdown. No extraordinary savings are planned, but the government says that it may have to revise this if the economic situation deteriorates[85]. The main reason for this concern is the international economic slow-down, not least in the ICT sector. The terrorist attack in the US has further added to the slow-down. The GDP-growth projection was revised from 3.5% to 1.7% from one convergence programme update to the next. Due to strong public finances, low unemployment and low expectations for inflation, the government does not expect Sweden to be unduly affected by international economic conditions[86]. However, the Swedish krona fell against the euro in 2001, even before the terrorist attack, but is expected to appreciate again in 2002.

Sweden decided in 1997 on a medium-term target for the public finances: the budget surplus should amount to an average of 2% of GDP over the business cycle. A successful result presupposes that expenditure is under control. Since 1997, the Riksdag has established nominal expenditure ceilings, which cannot be exceeded without the Riksdag passing a resolution to that effect[87]. The aim of achieving a surplus of 2% of GDP over a business cycle has since remained. The convergence programme update foresees a net lending of 2.1% of GDP in 2002 and 2.2 and 2.3 for 2003 and 2004 respectively. Thus, the government, in line with its medium-target, is more optimistic than the Commission Autumn forecast as well as the OECD, based on higher GDP growth targets. The government expects that discretionary fiscal policy will contribute 1.7% of GDP and that tax and expenditure reforms will increase disposable income by 1.4% of GDP. In total, however, government expenditure will decrease slightly over the next three years according to the convergence programme update.

Sweden can be said to have responded well to the general recommendations in the BEPGs 2000 and 2001. Sweden showed good progress in implementing the country-specific guidelines. Measures have been taken in response to recommendations on lowering the tax burden. Both in 2000 and 2001 measures were taken to reduce the taxation on low and middle-income earners (achieved by compensating for individual contributions used to finance earnings-related and supplementary pensions and by raising the limit for national income tax so that fewer wage earners pay national income tax) and this work will continue. The tax cuts made in 2000 and 2001 amount to about 1.5% of GDP in total. Sweden has also continued the strategy of maintaining high government surpluses and reducing public debt. The government has stressed the importance of wage restraint to the social partners. A mediation institute was creatd by the state in 2000 with the task both of mediating in labour conflicts and supporting the wage formation process.

Several new initiatives were launched in the budget bill for 2002[88], presented in September 2001: lower taxation on income (again achieved by compensating for individual contributions used to finance earnings-related and supplementary pensions and by raising the limit for national income tax); lower tax on real estate (property); lower taxation on income from

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85 Ministry of Finance, "Regeringens proposition Prop. 2001/02:1 Budgetpropositionen för 2002", Finansdepartementet, Stockholm, 2001.

86 Ringholm, B., "Vi räknar med ökad tillväxt", *Dagens Nyheter*, Stockholm, 20 September 2001.

87 Cf. Ministry of Finance, "Sweden's Convergence Programme 1998-2001", Stockholm, December 1998.

88 Cf. Ministry of Finance, "Regeringens proposition Prop. 2001/02:1 Budgetpropositionen för 2002", Finansdepartementet, Stockholm, 2001.

capital property (achieved by raising the limit so that fewer pay such tax); making child care fees less dependent on income (setting a ceiling on child care fees, also intended to improve job incentive and avoid poverty traps); and reduced VAT on books. The disposable income of households is expected to raise by 2.7% during 2002. Taxation on energy, carbon dioxin, and waste will instead increase as part of a green tax shift. The proposed tax reductions are expected to contribute to an increase in disposable income of households and thus to consumption and savings. The employers organisation, the centre-right opposition, and some bank economists state, however, that while households are targeted in the budget bill, sufficient attention has not been paid to enterprises[89].

The recommendations related to the functioning of **labour markets** and the need to reduce taxation on labour are potentially controversial in the eyes of the Swedish government. Sweden is repeatedly recommended to pursue reforms of tax and benefit systems to promote work incentives and reduce the tax burden for low income earners. The tax reductions in 2000 and 2001 are seemingly not considered enough in the view of the Commission and Council; and it is true that total labour costs have in fact increased in 2001[90]. In February 2001, a reform of the unemployment benefit insurance was implemented. Formally the new rules are less strict but in practice they are supposed to be more effective, since the former rules were unevenly implemented. Pressure on occupational and geographical mobility of unemployed persons has increased through the tightening of benefit rules. Sweden has also adopted a long-term approach to removing poverty traps and reducing marginal effects. Still, labour market policy is the field where Sweden is least in accord with the EU's views.

One recommendation, which is repeated each year to Sweden, and which is controversial in principle, concerns the need for lower taxes. It is controversial in principle because the Swedish position is that taxes are an issue of national competence. Part of the employment policy recommendations in 2000, Sweden was invited to set a goal for the tax reductions. However, this has not been implemented. In the view of the Swedish government, to have European goals for the level of taxation is not in line with the subsidiarity principle. In addition, to have high taxes is considered a political choice and the NAP for 2000 states that "The primary purpose of taxes is to finance the welfare system and thereby contribute to social security and justice"[91]. Moreover, Sweden has objections to the way in which the level of taxation is measured in the EU. The Swedish view is also that the issue of the size of the public sector or the size of public expenditure is not a matter for discussion at the EU level so much as the structure of taxation. Another matter of disagreement concerns labour market regulation, where particularly the OECD considers Swedish regulation to be too strict. The government does not agree that the introduction of further flexibility is necessary. In conclusion, although this is not shared by all national actors in Sweden, both the policy direction of lowered taxation and review of tax and benefit systems to avoid marginal effects and poverty traps can be understood partly as a result of EU economic coordination.

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[89] Cf. *Dagens Industri*, 21 September 2001.

[90] Cf. Junestav M., "Labour Cost Reduction, Taxation and Employment. The Swedish Case" Draft Paper prepared for the SALTSA Workshop "The Transposition of European "Soft" Social Policy Measures at National Level", Brussels, 2001.

[91] According to Junestav, the unwillingness to set a target for taxes is also an implication of a certain economic theory that denies a connection between taxes and employment. Cf. Junestav M., "Labour Cost Reduction, Taxation and Employment. The Swedish Case", Draft Paper prepared for the SALTSA Workshop "The Transposition of European "Soft" Social Policy Measures at National Level", Brussels, 2001.

In regard to the reform of **product markets and the knowledge-based economy**, Sweden has been at the forefront of opening markets for competition, e.g. as regards electricity, telecommunications, postal services and transport sectors such as taxi, bus, railway and domestic air traffic. Moreover, Sweden is in the forefront as regards ICT-related production and use of the internet as well as the development of new financial markets, such as fund savings. Competition policy has been strengthened. And yet, looking at the current competition situation, not all the intentions of the reforms have been met. Consumers have not yet benefited to the extent that was expected from market liberalisation, at least not in terms of lower consumer prices. Concentration has increased in some sectors when the companies are preparing for a Europe-wide market, the consequence being that they achieve an increasingly dominant position in Sweden, e.g. the electricity, petroleum and banking sectors. That liberalisation does not automatically benefit consumers, perhaps providing a lesson for others. Still, the national Cardiff report for 2000 estimates that the deregulation of telecommunications and electricity has contributed to lower inflation in 1999 by 0.3 percentage points, and has thus led to considerable gains for the Swedish economy. Both on electricity and telecomms, prices are lower in Sweden than the EU average[92].

The recommendations related to structural reform of product, service and capital markets are, however, well in line with the government's general policy. On product markets, Sweden has been recommended to increase competition in particular sectors: retail and wholesale trade and construction. Sweden has also been recommended to continue improving competition in air transport and pharmaceuticals and to continue to enhance efficiency in public procurement and the provision of public services. Measures have been taken in response to all the guidelines, not always leading to concrete results in 2001. However, the Commission in its report on the implementation of the 2000 broad economic guidelines commented that the opening up of public procurement remains insufficient and that there is scope for further progress in increasing the efficiency of public services. A permanent committee to deal with quality and development issues related to public procurement is now planned for 2002.

On **capital markets**, some progress has been made with regard to the adaptation of the fiscal framework in order to develop the risk capital market to make it more conducive to investment and entrepreneurship. A committee was set up to review the tax rules relating to dividends and capital gains. Corporate and capital taxation in order to stimulate entrepreneurship and investment are currently being simplified. Legislative measures on the adjustments of bankruptcy law are planned for early 2002 based on proposals of the Right of Property Committee.

## 5.15. **United Kingdom**

With regard to **budgetary policy**, the government's financial position is very strong, with current budget surpluses, low levels of debt and very limited pension liabilities in the long term. This financial position has been achieved despite a comparatively low level of taxation. Fiscal policy over the next two years will be driven by ambitious plans designed to boost public expenditure. Macroeconomic stability remains a high priority, however, with plans in place to achieve a public sector expenditure to GDP ratio of 37.2% in 2002-03, and a

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[92] Regeringskansliet, Näringsdepartmentet, "Benchmarking av näringspolitiken 2001. Indikatorer inom åtta områden som påverkar ekonomisk tillväxt", *Departementsserien (Ds)* no. 2001:20, Stockholm, 2001. On the politics of structural reform in Sweden, cf. Jacobsson K., "The Cardiff Process of Structural Reform in Sweden", Paper presented at the ETUI seminar on "Structural reform in Europe. A Trade union perspective on the Cardiff Process", Brussels, 2001.

reduction of general government gross debt to 36.6% by 2005-06. The most important development is the expansion of public expenditure with increased current and capital expenditure concentrated particularly on education and health, plus additional investment in transport. The motivation here is domestic concern over the poor state of public services in the UK.

The UK had a surplus of 2.0% of GDP for the fiscal year 2000-2001, but in the December 2001 convergence programme this is predicted to become a deficit of 0.3% of GDP for 2001-2002. This is the result of lower tax receipts as growth has slowed, higher current spending and a significant increase in investment. Deficits of around 1% of GDP are predicted from 2002-2003 to the end of the forecast period 2006-2007. These are consistent with the UK's Code for Fiscal Stability and Golden Rule because the borrowing is well below the much increased level of net investment. There is, however, a difference in interpretation between the UK Government and the Commission/Council as to whether this is consistent with the Stability and Growth Pact's objective of a medium term budgetary position that is "close to balance or in surplus". In all other respects the general policy orientations of the BEPG are broadly accepted in the UK.

With regard to public investment, the UK was encouraged in the BEPGs 2000 to boost substantially the ratio of fixed investment to GDP. As the Commission subsequently acknowledged, the UK made some progress towards this goal when net government net investment as a share of GDP rose from 0.4% in 1999-2000 to 0.7% in 2000-01, following the government's second comprehensive spending review. In an appeal for further progress in this field, the BEPGs 2001 calls upon the UK government to honour its commitment to double public investment (net of depreciation) as a share of GDP between the period 2000-01 and 2003-04. The latest Public Expenditure Statistical Analyses (PESA) clearly reveals that the UK remains on course to achieve this goal[93].

[93] Her Majesty's Treasury, "Public Expenditure Statistical Analyses", presented to Parliament by the Chancellor of the Exchequer by Command of Her Majesty in April 2000, The Stationary Office, London, 2001.

On **labour markets**, the BEPGs advocate active policy measures, designed to boost the employability of disadvantaged groups, in particular the long-term and young unemployed. Alongside this, the guidelines stress the need to reform passive labour market policy so as to reduce disincentives to work. The UK, in particular, is urged to address the spatial dimension to unemployment with the aim of lowering the proportion of households with no one at work. Moreover, the UK is encouraged to provide a "fresh start" to individuals within the first 12 months of unemployment. The UK has accordingly extended the New Deal to target groups that face a high risk of unemployment. Alongside such policy developments, an integrated programme of benefits and employment advice and work-focused interviews, known as ONE, is being piloted at present. At this comparatively early stage, the New Deal can claim considerable success, with an additional 305,240 young people moving from benefit to work since 1998 and youth unemployment down to 75% of the 1997 level[94].

Aside from advocating stronger active labour market policies, the BEPGs in 2000 and 2001 called on Member States in general and the UK in particular to reform tax and benefit systems with the aim of increasing the incentives to work. The UK has responded to these recommendations in the context of its Welfare to Work Programme. The centrepiece of this initiative is the Working Families Tax Credit (WFTC), which guarantees a minimum income for working families in excess of the minimum wage, improved childcare tax credit and lower rates of marginal tax and benefit withdrawal. Initial studies have suggested that the WFTC will induce a modest increase in the overall labour supply[95]. Such findings also augur well for the success of a working tax credit for childless people, scheduled for introduction in 2003. Work incentives for low income workers were further by the introduction in May 1999 of a 10% starting rate of income tax, which was complemented in the 2001 budget by a widening of the tax bands relating to this starting rate and a reduction in the basic rate of tax to 22%.

With regard to the **product markets and the knowledge-based economy**, Research and Development (R&D) plays a key role in the development of a Knowledge-Based Society. The BEPGs 2000 call upon the UK to reverse the trend of declining R&D efforts. The UK response was a revised and updated R&D policy in a White Paper on Science and Innovation (July 2000), the paper unveiled plans for a £ 1 billion programme of investment in the UK's scientific infrastructure, alongside a £ 140 million investment to improve the working relationship of business and the research community. Altogether the 2000 Spending Review allocates an additional £ 725 million to the Science budget over the periods 2001–02 to 2003–04.

A knowledge-based society requires that individuals have both the opportunities to use information technology and the skills to benefit from it. Thus, low-cost high-speed internet access is an objective of the BEPGs 2000, but although off-peak access charges are low in the UK , the development of high-speed internet access has been slow and patchy and broadband charges remain high. Government measures have so far had little impact on this problem. The BEPGs 2001 challenge to increase the supply of skilled personnel is being tackled within the context of the New Deal, which is designed to equip unemployed people with skills that are in

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[94] Cf. Riley R. and Young G., "Does welfare-to-work policy increase employment?: Evidence from the UK New Deal for Young People", National Institute for Economic and Social Research, *Discussion Paper* no. 183, London, 2001.

[95] Cf. Blundell R. and Reed H., "The Employment Effects of the Working Families Tax Credit", The Institute for Fiscal Studies, *Briefing Note* no. 6, London, 2000.

high demand. Likewise, the government is well on course to meet its obligations under the BEPGs 2000 on internet access in schools.

Efficient product markets promoted under the BEPGs, require increased competition, effective competition policy and liberalisation. The UK in particular is called upon to bolster competition in the retail banking services, car retailing and postal services and to reform of its transport system. The UK has shown considerable initiative in responding to these guidelines. There has been a radical overhaul of competition policy. The 1998 Competition Act – whose major provisions were finally implemented in 2001 – achieves a closer approximation between UK and EU procedures. Plans for a further reform of competition policy are set out in the government's White Paper on Productivity and Enterprise (July 2001).

The already extensive liberalisation of the UK economy is being further developed in relation to postal services and energy markets. A new Postal Services Act came into effect in July 2000 with the aim of boosting competition in postal services. A new energy regulator – the Gas and Electricity Markets Authority – was established in 2000 under the new Utilities Act to promote effective competition in the liberalised gas and electricity markets. While progress in the field of utilities liberalisation has been welcomed by Ecofin, the UK has been criticised for failing to co-ordinate "the procurement procedures of entities operating in the water, energy, transport and telecommunications sectors", thus violating Directive 98/4/EC. The Commission has referred this matter to the European Court of Justice.

Transport remains a problem; the July 2000 long-term strategy for transport has yet to bear fruit. Despite a planned 75% increase in investment over the previous decade and an integrated approach, years of under-investment continue to dog the system. Thus, train and London Underground reliability have been falling and doubts are being expressed about the viability of the public-private partnership (PPP) to deliver the investment -a situation not helped by the bankruptcy in October 2001 of Railtrack the company, which owns the track and stations of the rail system.

In order to enhance efficient and integrated **capital markets**, the commitment to implement this action plan is reinforced in the BEPGs 2001 along with other recommendations for capital market reform. The UK in particular is urged to address the high failure rate amongst SMEs, while tackling weaknesses in its capital market, which limit investment by pension funds in risk capital. The publication in March 2001 of the Myner Review of Institutional Investment goes some way towards addressing this problem. In turn the UK government has adopted Myner's recommendation to replace the Minimum Funding Requirement (MFR) with a system that is less biased towards investment in UK-quoted equities and gilt.

With regard to retail banking, the Financial Services and Markets Act received Royal Assent in June 2000. Under the terms of this act, a Financial Services Authority becomes the statutory regulator for the industry as whole, replacing a system that had separate regulators for different financial services. The objective of the act is to deliver a consistent level of consumer protection across all financial institutions. Consumer rights are protected in this regard through the establishment of a single Ombudsman to cover all aspects of financial services.

## Chapter VI – *OVERVIEW ON THE IMPLEMENTATION OF COUNTRY SPECIFIC RECOMMENDATIONS*

The following table summarises the implementation record of Member States in dealing with the country specific recommendations included in the BEPGs. Complementary recommendations in the opinions of Ecofin on the stability and convergence programme updates for 2000/2001 have not been included, as most of these recommendations simply repeat the more detailed recommendations contained in the BEPGs.

The summary table uses the criteria for assessing implementation adopted by the Commission in its report on the implementation of the BEPGs. Careful examination of the report suggests that the difference between "partial implementation" and "implementation in progress" is not always unambiguous. "Partial implementation" is apt to be used not only when the policy action is incomplete, but also where the country-specific recommendation includes more than one measure. Beyond the obvious definition, "Implementation in progress" is also used in those cases where the recommendations refer to an ongoing process, e.g. "develop further the risk-capital market".

## Table 6.1 Synthetic summary of the implementation of country specific recommendations included in the BEPGs 2001

| *Member State* | *Policy area* | *No. of specific recommen-dations* | *full implementation* | *partial implementation* | *implementation in progress* | *no implementation* |
|---|---|---|---|---|---|---|
| **Belgium** | Budgetary policy | 4 | 1 | 2 | | 1 |
| | Labour markets | 3 | | 3 | | |
| | Product markets, knowledge-based economy | 3 | | 3 | | |
| | Capital markets | 1 | | 1 | | |
| **Denmark** | Budgetary policy | 3 | 1 | 2 | | |
| | Labour markets | 1 | | | 1 | |
| | Product markets, knowledge-based economy | 2 | | | 2 | |
| | Capital markets | 1 | | | 1 | |
| **Germany** | Budgetary policy | 4 | | 1 | 1 | 2 |
| | Labour markets | 3 | | 2 | | 1 |
| | Product markets, knowledge-based economy | 3 | | 1 | 2 | |
| | Capital markets | 1 | | | 1 | |
| **Greece** | Budgetary policy | 4 | | 3 | | 1 |
| | Labour markets | 4 | | 2 | 1 | 1 |
| | Product markets, knowledge-based economy | 5 | | 3 | 2 | |
| | Capital markets | 1 | | 1 | | |
| **Spain** | Budgetary policy | 3 | 1 | 2 | | |
| | Labour markets | 3 | | 2 | 1 | |
| | Product markets, knowledge-based economy | 2 | | | 2 | |
| | Capital markets | 1 | | | 1 | |
| **France** | Budgetary policy | 3 | | 2 | | 1 |
| | Labour markets | 3 | 1 | 2 | | |
| | Product markets, knowledge-based economy | 4 | | | 2 | 2 |
| | Capital markets | 1 | | 1 | | |
| **Ireland** | Budgetary policy | 4 | | 4 | | |
| | Labour markets | 2 | 1 | 1 | | |
| | Product markets, knowledge-based economy | 3 | | 1 | 2 | |
| | Capital markets | 1 | | | 1 | |
| **Italy** | Budgetary policy | 4 | | 2 | 1 | 1 |
| | Labour markets | 3 | | 2 | | 1 |
| | Product markets, knowledge-based economy | 4 | | 4 | | |
| | Capital markets | 1 | | | | 1 |

## Table 6.1 Summary of the implementation of country specific recommendations included in the BEPGs 2001 (cont.)

| *Member State* | *Policy area* | *No. of specific recommen-dations* | *full implementation* | *partial implementation* | *implementation in progress* | *no implementation* |
|---|---|---|---|---|---|---|
| **Luxembourg** | Budgetary policy | 2 | 2 | | | |
| | Labour markets | 1 | 1 | | | |
| | Product markets, knowledge-based economy | 1 | | | 1 | |
| | Capital markets | 0 | | | | |
| **Netherlands** | Budgetary policy | 3 | 2 | | 1 | |
| | Labour markets | 1 | | | 1 | |
| | Product markets, knowledge-based economy | 2 | | | 2 | |
| | Capital markets | 1 | | | 1 | |
| **Austria** | Budgetary policy | 3 | 1 | 1 | 1 | |
| | Labour markets | 1 | | 1 | | |
| | Product markets, knowledge-based economy | 2 | | | 2 | |
| | Capital markets | 1 | | | 1 | |
| **Portugal** | Budgetary policy | 3 | | | 1 | 2 |
| | Labour markets | 2 | | 1 | 1 | |
| | Product markets, knowledge-based economy | 5 | | | 5 | |
| | Capital markets | 1 | | 1 | | |
| **Finland** | Budgetary policy | 3 | | 2 | 1 | |
| | Labour markets | 2 | | | 2 | |
| | Product markets, knowledge-based economy | 2 | | 1 | 1 | |
| | Capital markets | 1 | | | 1 | |
| **Sweden** | Budgetary policy | 3 | 1 | 1 | 1 | |
| | Labour markets | 2 | | 1 | 1 | |
| | Product markets, knowledge-based economy | 2 | | | 2 | |
| | Capital markets | 1 | | | 1 | |
| **United Kingdom** | Budgetary policy | 3 | | 1 | 1 | 1 |
| | Labour markets | 1 | 1 | | | |
| | Product markets, knowledge-based economy | 2 | | | 2 | |
| | Capital markets | 1 | | | 1 | |
| **Overall summary** | Budgetary policy | 49 | 9 | 23 | 8 | 9 |
| | Labour markets | 32 | 4 | 17 | 8 | 3 |
| | Product markets, knowledge-based economy | 42 | 0 | 13 | 27 | 2 |
| | Capital markets | 14 | 0 | 4 | 9 | 1 |

# PART III – ECONOMIC CONVERGENCE AND PROSPECTS

## Chapter VII – *THE GLOBAL ECONOMIC CONTEXT*

As a major trading bloc, the EU cannot insulate itself from developments in the global economy and the trends in the last year have, on the whole, been adverse, notably the slide into recession in the US and Japan since the end of 2000. Yet, at much the same time, oil prices had reached a cyclical peak, a development that contributed to a jump in the headline rate of inflation in many countries. The uncertainty about the depth and duration of the US recession, tragically aggravated by the events of 11 September 2001, have led to considerable difficulty in forecasting the key macroeconomic, with most forecasters progressively becoming more pessimistic in projections published in the latter half of 2001. However, with monetary authorities on both sides of the Atlantic having acted pretty decisively, and with the respective economies reasonably sound on "fundamentals", the likelihood is that the slowdown will be short-lived, and the latest private forecasts are now confirming the mainstream forecasters' view that recovery is in sight.

**Table 7.1. The Global Economic Outlook: An overview of the latest forecasts**

| | EU Commission | OECD | IMF | UBS Warburg |
|---|---|---|---|---|
| **EU** | | | | |
| **2000** | 3.3 | 3.3 | 3.4 | 3.3 |
| **2001** | 1.7 | 1.7 | 1.7 | 1.6 |
| **2002** | 1.4 | 1.5 | 1.3 | 1.3 |
| **2003** | 2.9 | 2.9 | - | 2.6 |
| **US** | | | | |
| **2000** | 4.2 | 4.1 | 4.1 | 4.1 |
| **2001** | 1.6 | 1.1 | 1.0 | 1.0 |
| **2002** | 0.5 | 0.7 | 0.7 | 0.5 |
| **2003** | 3.4 | 3.8 | - | 3.5 |

*Source: European Commission, "Autumn 2001 Forecasts for 2001-2002", European Economy, Supplement A, Economic Trends, No 11/11, October/November 2001. OECD, OECD Economic Outlook, No. 70, December 2001,*
*IMF, World Economic Outlook December 2001: The Global Economy After September 11, International Monetary*
*Fund, Washington DC, 2001; UBS Warburg, Review of 2001, UBS Warburg, London:, 2001*

The slowdown in the US economy, which began in the final quarter of 2000, and the unstable geopolitical environment which emerged in September 2001 have had a significant impact on growth prospects in the EU economy. With regard to the latter, there are four main *transmission mechanisms* through which the events of 11 September have affected the global macroeconomic environment[96]: the first surrounds the tragic loss of life, the destruction of property and the disruption to the aviation, tourist and leisure industries; the second is associated with the damage to consumer and investor confidence with regard to the prospect for recovery; the third is linked to the response of financial markets to the increased economic

[96] IMF, "The IMF World Economic Outlook, The Global Economy After September 11", *International Monetary Fund*, Washington DC, December 2001.

uncertainty; the fourth is associated with developments in global commodity markets, where commodity prices in general and oil prices in particular have weakened as demand has slowed; the net impact of these factors on the EU economy account, in large measure, for the substantial revision in the Commission's economic forecasts between the Spring and Autumn of 2001. During this period, the Commission's growth forecasts for 2001 and 2001 were cut by 1.2 and 1.6 percentage points, respectively.

Despite the remaining uncertainties amongst forecasters about the prospects for, and timing of, an economic recovery in the EU there can be little doubt that the fortunes of the US economy will have an influence. As can be seen in Table 7.1 the general consensus amongst the forecasters surveyed here is for the US slow-down to "bottom out" early in 2002 at a growth rate ranging from 0.5% to 0.7%. The recovery will be a marked one, with growth returning towards 2000 rates by 2003. The EU is expected to follow a similar course, with economic growth stalling in 2002 at rates of between 1.3% and 1.5% and then recovering towards rates of between 2.6% and 2.9%. Thus, from a macroeconomic forecasting perspective, the assessment of 11 September is that while geo-political turbulence may have prolonged the economic slowdown in the short-term by adding to an already uncertain economic environment, such turbulence is unlikely to harm the medium-term growth potential of the advanced industrial economies.

## Chapter VIII – *THE OBJECTIVE OF CONVERGENCE*

Article 2 of the Treaty Establishing the European Community lists amongst its objectives the desire to promote a "high degree of convergence of economic performance". In addition to being an *intrinsic* objective, convergence was also an *entry requirement* for the third and final stage of EMU, and remains as a condition for prospective new adherents to the single currency. It was in the context of EMU that the Union's understanding of convergence was fleshed out. In essence it revolves around the fulfilment of the four convergence criteria set out in article 121 TEC. Convergence is defined in this context as:

- The achievement of a high degree of price stability.
- The sustainability of the government financial position.
- The observance of the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System, for at least two years without devaluing against the currency of any other Member State.
- The durability of convergence achieved by the Member State and of its participation in the exchange-rate mechanism of the European Monetary System being reflected in the long-term interest-rate levels.

The objective of convergence is promoted at the EU level by the closer coordination of Member States' economic policies in general, and in particular through the BEPGs (BEPG) and the process on multi-lateral surveillance (Article 99(3) TEC).

In March 1998, the European Monetary Institute – the forerunner to the European Central Bank – published a Convergence Report in accordance with Article 109j TEC, to assess the extent and sustainability of economic convergence within the European Union. Of the fifteen Member States, twelve were deemed to be in accordance with the four criteria. Of the remaining three, the United Kingdom, Greece and Sweden – as non-participants in the exchange rate mechanism – broke the nominal exchange rate criteria, while Greece also failed the price stability, long-term interest rate and fiscal sustainability requirements. In terms of entry to EMU, the picture of convergence remains largely the same today as it did in 1998.

The exception is Greece, which was deemed by the ECB, in its May 2000 Convergence Report, to have now fulfilled all four criteria. Greece duly became the twelfth participant in stage three of EMU on 1 January 2001.

As an intrinsic objective of the Union, however, the achievement of convergence in economic performance is far from being a one-shot game. Its relevance in a Union of ever-increasing economic interdependence is continuous, not least for the sake of achieving of a high level sustainable and non-inflationary growth and for the smooth functioning of EMU. This fact raises questions about the current extent of convergence for participants and non-participants of EMU alike and for the prospect of continued convergence in the light of prevailing economic circumstances. In answering this question, the Maastricht Criteria may continue to serve as the essential indicators of convergence.

### 8.1. **The pursuit of price stability**

An annual measure of change in consumer prices over the last decade is presented in Table 8.1.1. As might be expected, there is a marked convergence towards price stability in the run-up to EMU, with the average rate of inflation falling from 4.4% in the period 1991-1995 to just 1.5% on the eve of monetary union. The standard deviation has fallen over the same period from 4.4 to 0.7 percentage points, indicating a closer clustering of prices around more stable levels. In spite of fears to the contrary, this trend has been maintained during the new currency's infancy. The average rate of inflation will remain at around 2% over the forecast horizon, while the standard deviation around this mean is expected to fall to around 0.4 percentage points. Over the longer term and even in recent memory, this reflects a picture of price stability and a state of close convergence. To be sure, moderate inflationary pressures were generated against the backdrop of a weak euro and rising oil prices, with the result that consumer prices rose by 2.6% and 2.9% in 2000 and 2001. According to both Commission and OECD forecasts, however, such pressures will gradually abate over the next two years in response to the sharp falls in oil prices and the attenuation of economic growth. Naturally, the speed of this adjustment will be contingent on any gains in the value of the euro on international currency markets.

Turning to a more disaggregated level, the three highest-inflation Member States of 2000 – Ireland, the Netherlands and Portugal – are expected to exert a tighter grip on prices. Most notable is the Netherlands, where inflation looks set to fall from 5.2% in 2000 to just 1.9% in 2001. The much-publicised price-effects of rapid economic growth in Ireland are also likely to gradually subside, with the rate of inflation forecast to fall from 5.3% in 2000 to between 3.2% and 2.9% in 2003.

### 8.2. **The pursuit of fiscal sustainability**

A broad overview of public finances in the Union over the last decade is presented in Tables 8.2.1 and 8.2.2. Once again, the convergence in the economic performance of Member States in the run-up to monetary union is evident. On average over the period 1991-95, the Member States ran a deficit of 4.9%. There was some deviation around this mean, however, with a standard deviation of 3.1 percentage points. This reflected comparatively large deficits in the likes of Greece (11.5%), Italy (9.1%), Sweden and the United Kingdom (6.0%). By 1999, public finances had converged to a more sustainable level, with an average fiscal position of 0.1% being realised. The standard deviation had fallen to 2.1 percentage points, even though some countries had, by then, moved substantially into surplus (Luxembourg, 3.7%; Denmark, 3.1%; Ireland, 2.3%; and Finland, 1.9%). Significant progress has been made with respect to the Union's stock of public debt. The average ratio of debt to GDP stood in 1995 at 73% of GDP, well in excess of the Maastricht Treaty's ratio of 60%. Dispersion around this mean was considerable (30.2 percentage points), reflecting the high levels of public debt in Belgium (133.4%), Italy, (123.3%) and Greece (108.7%). A concentrated effort on the part of Member States pushed this ratio down to 64.4% in 1999, which was above but at least approaching the desired ratio of 60%. Belgium (115.9%), Italy (114.6%) and Greece (108.5%) remained well off this average, however, so that the standard deviation was still relatively high at 27.5 percentage points.

Fears were raised in the run-up to EMU about the prospect for continued fiscal convergence once the "carrot" of membership had finally been eaten. Once inside monetary union, in other words, a member state would have little incentive to keep to the entry requirements since membership is virtually irrevocable. In the absence of carrots, "sticks" such as the Stability and Growth Pact and the Broad Economic Guidelines have prevented fiscal profligacy and, arguably, engendered a more responsible approach to fiscal policy-making. The average fiscal position looks set to rise over the Commission's forecast horizon to around 0.5%. The Commission forecast view is largely echoed by the OECD's forecasts, both of which demonstrate convergence in that the standard deviation around the new average looks set to fall to around 1.3% in 2003. The global economic slowdown will lead to a deterioration in the Union's fiscal position as automatic budgetary stabilisers begin to operate and discretionary fiscal policy is relaxed, with Belgium, France, Germany, Austria and Portugal expected to move into a deficit position between 2000 and 2003. It is, however, important to note that the change affects all countries. The most significant adjustment will come from Germany, where the deficit is expected to rise to 2.7% in 2002, according to the Commission forecasts. According to both the Commission and the OECD, however, the fiscal position will tighten in 2003 to between 2.2% and 1.8%, thus leaving Germany in conformity with the Stability and Growth Pact, despite expectations that the ceiling would be breached and the Excessive Deficit Procedure invoked. A similar picture is revealed upon inspection of the government debt forecasts. The average level of debt will fall in the opinion of both the Commission and the OECD to around 54% in 2003, thus leaving the Union well within the Maastricht definition of fiscal sustainability. Further improvement is expected on the part of Belgium (98.9%), Italy (103.4%) and Greece (95.1%), although there is clearly some scope for further reductions. Of moderate concern too is Germany, where the relaxation in the fiscal position will be reflected in the opinion of the OECD by an increase from a level of 60% in 2001 to one of 61% in 2002. This change is tiny when the forecast error is taken into account and the forecasts also suggest that Germany's debt ratio is set to fall again in 2003.

## 8.3. **Exchange rate and long term interest rate convergence**

Turning to the non-participating Member States, Table 8.3.1. records bilateral exchange rates with respect to the euro and before it the ECU. Of the three, Denmark is the sole member of the exchange rate mechanism of the European Monetary System. This accounts for the greater stability of the Danish krone when compared with the Swedish krona and sterling over the forecast horizon. The Danish krone looks set to remain at its ERM II reference rate of 7.46 krone to the euro for the foreseeable future. The Swedish krona, in contrast, is expected to fall from a rate of 8.81 krona to the euro in 1999 to a rate of 9.64 by 2003. Sterling gained against the euro from 1999 to the present, with its rate rising from 66 pence to the euro in 1999, but is expected to slip slightly from today's rate to 63 pence by 2003. Even in the light of these forecasts, however, the non-participating Member States of EMU enjoy a comparatively stable relationship with the euro as reflected by trends in the long-term interest rate (regarded as predictors of long-term inflation), as recorded in Table 8.3.2. Euro-zone interests have not surprisingly converged to markedly lower rates over the last decade as a result of convergence and then monetary unification. The same is true of the non-participating Member States, however. Long-term interest rates in Denmark have converged from 8.5% over the period 1986 – 90 to 5.1% in 2001. Swedish rates have fallen over the same period from 11.7% to 5.1%, while the long-term interest UK rates fell from 9.9% to 4.9%. In the Maastricht Treaty's own terms, this is evidence of a durable convergence between the non-participating Member States and the euro zone.

## 8.4. **Conclusions**

In an exploration of the concept of convergence in the context of the recent White Paper on European Governance, it was noted that "[national policy] convergence relates to performance and not necessarily the policies implemented by the Member States"[97]. The evidence presented in this section points towards a marked and continued economic policy convergence in the EU and euro zone alike. In both the run-up to monetary union and over the forecast horizon, the economic policies of the Member States have conformed to the convergence criteria of price stability, fiscal sustainability and nominal exchange rate stability. Although recent economic events will require an adjustment in macroeconomic policies it is unlikely that this adjustment will jeopardize the objective of convergence in any real sense.

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[97] Working Group 4a, "Involving Experts in the Process of National Policy Convergence", *Group Report for the European Commission's White Paper on Economic Governance*, Office for Official Publications of the EC, Luxembourg. 2001, p.7.

## Table 8.1.1. Consumer Prices

percentage change on previous year, 1995-2003

| | 1991-95+ | 1996+ | 1997+ | 1998+ | 1999 | 2000 | 2001* | 2001** | 2002* |
|---|---|---|---|---|---|---|---|---|---|
| **Belgium** | 2.7 | 2.3 | 2.3 | 3.4 | 1.1 | 2.7 | 2.4 | 2.3 | [illegible] |
| **Denmark** | 1.8 | 2.5 | 3.7 | 3.5 | 2.1 | 2.7 | 2.3 | 2.1 | [illegible] |
| **Germany** | 3.5 | 1.7 | 0.7 | 2.3 | 0.6 | 2.1 | 2.4 | 1.9 | [illegible] |
| **Greece** | 13.8 | 8.5 | 2.7 | 2.1 | 2.1 | 2.9 | 3.6 | 3.3 | [illegible] |
| **Spain** | 5.6 | 3.4 | 2.9 | 4.1 | 2.2 | 3.5 | 3.7 | 3.7 | [illegible] |
| **France** | 2.3 | 1.8 | 0.2 | 3.4 | 0.6 | 1.8 | 1.8 | 1.7 | [illegible] |
| **Ireland** | 2.5 | 1.4 | 7.3 | 7.5 | 2.5 | 5.3 | 4.0 | 4.2 | [illegible] |
| **Italy** | 5.7 | 4.3 | 2.5 | 1.8 | 1.7 | 2.6 | 2.7 | 2.8 | [illegible] |
| **Luxembourg** | 3.0 | 1.6 | 3.8 | 2.3 | 1.0 | 3.8 | 2.6 | 2.6 | [illegible] |
| **Netherlands** | 2.5 | 1.6 | 2.6 | 4.1 | 2.0 | 2.3 | 5.2 | 4.6 | [illegible] |
| **Austria** | 3.0 | 2.5 | 0.1 | 1.5 | 0.5 | 2.0 | 2.4 | 2.6 | [illegible] |
| **Portugal** | 7.7 | 3.6 | 3.2 | 4.7 | 2.2 | 2.8 | 4.3 | 4.3 | [illegible] |
| **Finland** | 3.1 | 1.7 | 2.9 | 5.5 | 1.3 | 3.0 | 2.7 | 2.6 | [illegible] |
| **Sweden** | 4.7 | 1.2 | 1.6 | 2.4 | 0.6 | 1.3 | 2.7 | 2.6 | [illegible] |
| **UK** | 4.1 | 2.6 | 4.0 | 2.7 | 1.3 | 0.8 | 1.3 | 1.5 | [illegible] |
| **Average** | 4.4 | 2.7 | 2.7 | 3.4 | 1.5 | 2.6 | 2.9 | 2.9 | [illegible] |
| **Std Deviation** | 2.9 | 1.8 | 1.7 | 1.5 | 0.7 | 1.0 | 1.0 | 0.9 | [illegible] |
| **EU-15** | 4.1 | 2.6 | 2.0 | 2.8 | 1.2 | 2.1 | 2.5 | - | [illegible] |
| **Euro-area** | 3.9 | 2.5 | 1.5 | 2.9 | 1.2 | 2.4 | 2.8 | - | [illegible] |

*Source: Commission (2001), (1999) and (1998).*
*+ Based on a Deflator for Consumer Prices rather than the Harmonised Consumer Price Index.*
** Based on Commission's November 2001 Forecasts.*
*** Based on latest OECD Forecasts.*

**Table 8.2.1. Net lending (+) or net borrowing (-), general governme**

(as a percentage of GDP, 1970-2003)

| | 1991-95 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001* | 2001** | 2002* |
|---|---|---|---|---|---|---|---|---|---|
| **Belgium** | -5.9 | -3.2 | -1.8 | -1.0 | -0.6 | 0.1 | 0.0 | 0.0 | -0. |
| **Denmark** | -2.4 | -0.7 | 0.1 | 0.9 | 3.1 | 2.5 | 2.2 | 2.0 | 1. |
| **Germany** | -2.9 | -1.5 | -2.6 | -1.7 | -1.6 | 1.2 | -2.5 | -2.5 | -2. |
| **Greece** | -11.5 | -7.5 | -3.9 | -2.5 | -1.8 | -1.1 | 0.0 | 0.2 | 0. |
| **Spain** | -5.6 | -4.7 | -3.1 | -2.3 | -1.1 | -0.3 | 0.1 | 0.0 | -0. |
| **France** | -4.6 | -4.1 | -3.0 | -2.7 | -1.6 | -1.4 | -1.5 | -1.5 | -2. |
| **Ireland** | -2.6 | -0.4 | 0.6 | 2.0 | 2.3 | 4.5 | 2.4 | 3.2 | 1. |
| **Italy** | -9.1 | -6.7 | -2.8 | -2.7 | -1.8 | -0.3 | -1.2 | -1.4 | -1. |
| **Luxembourg** | 1.7 | 2.9 | 3.8 | 2.5 | 3.7 | 6.1 | 4.4 | - | 2. |
| **Netherlands** | -3.5 | -5.1 | -1.2 | -0.8 | 0.4 | 2.2 | 1.3 | 1.1 | 0. |
| **Austria** | -3.8 | -3.7 | -1.9 | -2.4 | -2.2 | -1.1 | -0.2 | 0.0 | -0. |
| **Portugal** | -5.0 | -3.3 | -2.0 | -1.5 | -2.1 | -1.5 | -2.0 | -1.7 | -1. |
| **Finland** | -4.8 | -3.5 | -1.6 | 1.4 | 1.9 | 6.9 | 4.8 | 3.7 | 2. |
| **Sweden** | -7.6 | -3.5 | -2.0 | 2.3 | 1.7 | 4.1 | 3.9 | 3.8 | 1. |
| **UK** | -6.0 | -4.7 | -2.0 | 0.2 | 1.2 | 4.3 | 1.2 | 2.2 | 0. |
| **Average** | -4.9 | -3.3 | -1.6 | -0.6 | 0.1 | 1.7 | 0.9 | 0.7 | 0. |
| **Std Deviation** | 3.1 | 2.6 | 1.9 | 1.9 | 2.1 | 2.9 | 2.3 | 2.0 | 1. |
| **EU-15** | -5.2 | -4.2 | -2.4 | -1.5 | -0.7 | 1.1 | -0.5 | - | -0. |
| **Euro-area** | -4.9 | -4.1 | -2.6 | -2.0 | -1.3 | 0.3 | -1.1 | - | -1. |

*Source: European Commission, "Autumn 1998 forecasts for 1998-2000", European Economy, Supplement A, Econo Publications of the EC, Luxembourg, October 1998; European Commission, "Autumn 1999 forecasts for 1999 – 200 Economic trends, No. 10/11, Office for Official Publications of the EC, Luxembourg, October/November 1999; European C 2001-2002", European Economy, Supplement A, Economic Trends, No 10/11, Office for Official Publications of the EC, and Datastream.*

* *Based on Commission November 2001 Forecasts.*

** *Based on latest OECD Forecasts.*

## Table 8.2.2. Central government debt

(as a percentage of GDP, 1970-2003)

| | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001* | 2001** | 2002* |
|---|---|---|---|---|---|---|---|---|---|
| **Belgium** | 133.4 | 126.5 | 121.2 | 119.7 | 115.9 | 110.3 | 107 | 104.4 | 10 |
| **Denmark** | 69.3 | 69.3 | 65.0 | 55.6 | 52.0 | 46.1 | 43.2 | 42.4 | 42 |
| **Germany** | 57.1 | 59.7 | 60.8 | 60.9 | 61.3 | 60.3 | 60.0 | 58.6 | 61 |
| **Greece** | 108.7 | 111.3 | 108.5 | 105.0 | 103.9 | 102.7 | 99.8 | 100.7 | 98 |
| **Spain** | 64.0 | 67.4 | 66.0 | 64.7 | 63.4 | 60.7 | 58.0 | 58.3 | 57 |
| **France** | 54 | 54.8 | 57.1 | 59.5 | 58.5 | 57.6 | 57.1 | 57.8 | 57 |
| **Ireland** | 84.3 | 71.1 | 62.2 | 54.8 | 49.3 | 38.6 | 34.3 | 29.5 | 30 |
| **Italy** | 123.3 | 122.5 | 120.2 | 116.4 | 114.6 | 110.5 | 108.2 | 106.7 | 106 |
| **Luxembourg** | 5.6 | 6.2 | 6.0 | 6.4 | 6.0 | 5.3 | 5.3 | 4.4 | 5 |
| **Netherlands** | 77 | 73.8 | 68.5 | 66.8 | 63.1 | 56.1 | 51.8 | 52.8 | 48 |
| **Austria** | 68.5 | 68.7 | 63.9 | 63.9 | 64.7 | 63.1 | 62.3 | 61.4 | 61 |
| **Portugal** | 64.1 | 63.8 | 60.4 | 54.7 | 54.5 | 53.7 | 53.5 | 53.2 | 53 |
| **Finland** | 57.1 | 56.5 | 53.9 | 48.8 | 47.3 | 44.0 | 42.7 | 39.5 | 42 |
| **Sweden** | 76.6 | 74.4 | 73.6 | 70.5 | 65.3 | 55.7 | 52.7 | 50.1 | 50 |
| **UK** | 51.8 | 52.6 | 51.2 | 48.1 | 45.7 | 42.8 | 39.3 | 41.6 | 37 |
| **Average** | 73.0 | 71.9 | 69.2 | 66.4 | 64.4 | 60.5 | 58.3 | 57.4 | 57 |
| **Std deviation** | 30.2 | 29.0 | 28.1 | 27.8 | 27.5 | 27.3 | 27.0 | 27.1 | 26 |
| **EU-15** | 70.2 | 71.4 | 70.5 | 69 | 67.5 | 64.4 | 62.5 | - | 61 |
| **Euro-area** | 72.9 | 73.9 | 73.8 | 73.7 | 72.7 | 70.2 | 68.8 | - | 68 |

*Source: European Commission, "Autumn 1998 forecasts for 1998-2000", European Economy, Supplement A, Econ Publications of the EC, Luxembourg, October 1998; European Commission, "Autumn 1999 forecasts for 1999 – 20 Economic trends, No. 10/11, Office for Official Publications of the EC, Luxembourg, October/November 1999; European 2001-2002", European Economy, Supplement A, Economic Trends, No 10/11, Office for Official Publications of the EC, Lu*

* *Based on Commission's November 2001 Forecasts.*

** *Based on latest OECD Forecasts.*

| Table 8.3.1. Nominal Bilateral Exchange Rates against the ECU/euro (1 | | | | | | | |
|---|---|---|---|---|---|---|---|
| | **1970-73** | **1974-85** | **1986-90** | **1991-95** | **1996-03** | **1999** | **2000** |
| **Denmark** | 7.66 | 7.53 | 7.94 | 7.64 | 7.45 | 7.44 | 7.45 |
| **Sweden** | 5.35 | 5.8 | 7.23 | 8.53 | 8.98 | 8.81 | 8.45 |
| **United Kingdom** | 0.45 | 0.59 | 0.69 | 0.76 | 0.67 | 0.66 | 0.61 |

*Source: European Commission, "Autumn 2001 Forecasts for 2001-2002", European Economy, Supplemen Office for Official Publications of the EC, Luxembourg, October/November 2001.*

**Table 8.3.2. Long Term Interest Rates (1986 – 2001)**

| | 1986-90 | 1991-95 | 1994 | 1995 | 1996 | 1997 | 1998 | 1 |
|---|---|---|---|---|---|---|---|---|
| **Belgium** | 8.5 | 8.1 | 7.8 | 7.5 | 6.5 | 5.8 | 4.7 | |
| **Denmark** | 10.8 | 8.7 | 7.9 | 8.3 | 7.2 | 6.2 | 4.9 | |
| **Germany** | 6.8 | 7.3 | 6.9 | 6.8 | 6.2 | 5.7 | 4.6 | |
| **Greece** | - | - | - | - | - | - | 8.5 | |
| **Spain** | 12.9 | 11.2 | 10.1 | 11.3 | 8.7 | 6.4 | 4.8 | |
| **France** | 9.1 | 7.8 | 7.3 | 7.5 | 6.3 | 5.6 | 4.6 | |
| **Ireland** | 10.2 | 8.5 | 8.1 | 8.3 | 7.3 | 6.3 | 4.8 | |
| **Italy** | 12.3 | 12.0 | 10.4 | 11.9 | 9.2 | 6.7 | 4.8 | |
| **Luxembourg** | 8.0 | 7.5 | 7.2 | 7.2 | 6.3 | 5.6 | 4.7 | |
| **Netherlands** | 7.1 | 7.4 | 6.9 | 6.9 | 6.2 | 5.6 | 4.6 | |
| **Austria** | 7.4 | 7.5 | 6.7 | 7.2 | 6.3 | 5.7 | 4.7 | |
| **Portugal** | 17.1 | 13.0 | 10.4 | 11.5 | 8.6 | 6.4 | 5.0 | |
| **Finland** | 11.7 | 9.8 | 8.4 | 8.8 | 7.1 | 6.0 | 4.8 | |
| **Sweden** | 11.7 | 10.0 | 9.5 | 10.2 | 8.1 | 6.7 | 5.0 | |
| **UK** | 9.9 | 8.5 | 8.1 | 8.2 | 7.8 | 7.0 | 5.5 | |
| **Average** | 10.3 | 9.1 | 8.3 | 8.7 | 7.3 | 6.1 | 5.1 | |
| **Std deviation** | 2.8 | 1.8 | 1.3 | 1.8 | 1.0 | 0.5 | 1.0 | |
| **EU-15** | 9.8 | 8.9 | 8.2 | 8.6 | 7.3 | 6.2 | 4.9 | |
| **Euro-area** | 9.7 | 9.0 | 8.1 | 8.6 | 7.2 | 6.0 | 4.8 | |

*Source: European Commission, "Autumn 1998 forecasts for 1998-2000", European Economy, Suppleme Office for Official Publications of the EC, Luxembourg, October 1998; European Commission, "Autumn 19 European Economy, Supplement A, Economic trends, No. 10/11, Office for Official Publicatio October/November 1999; European Commission, "Autumn 2001 Forecasts for 2001-2002", European Eco Trends, No 10/11, Office for Official Publications of the EC, Luxembourg, October/November 2001.*

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