ECONOMIC POLICY COMMITTEE

Brussels, 13 March 2000

Annual Report on Structural Reforms 2000

– Report addressed to the Council and the Commission –

Content

Preface

This is the second "Annual Report on Structural Reforms" by the Economic Policy Committee. It summarises the results of a country by country examination carried out in a Committee working group involving all 15 Member States, the Commission and the European Central Bank. The report also builds on Member States' reports on structural reforms, on Member States' National Action Plans for Employment, the Joint Employment Report, the Commission's Cardiff report and other useful contributions from the Commission services. Valuable input has also been provided by the Working Party on the Internal Market (Horizontal Questions).

The peer review in the Economic Policy Committee and the Annual Report on Structural Reforms contribute to the preparation of the multilateral surveillance by the Council according to Article 99 (3) of the Treaty. It incorporates the "Cardiff-process" for monitoring economic reform in Member States, which the Ecofin-Council launched on 1 May 1998.

In accordance with the report the Ecofin-Council submitted to the European Council in Helsinki[1], special focus has this time been put on policies for promoting R&D and the long-term sustainability of public finances, including the challenges stemming from ageing populations.

The report provides an input to the formulation of the Broad Economic Policy Guidelines (BEPG), which form the centre of economic policy co-ordination within the European Union.

The reviews confirm, in line with the conclusions from the Helsinki Council, that the Luxembourg and Cardiff processes – together with the macroeconomic dialogue – form a comprehensive entity, which produces results. They provide mutual inspiration drawing on benchmarking and peer reviews, while respecting the principle of subsidiarity. Their efficiency will gain from continuity and adjustments in line with experience. New priorities can be integrated, while new procedures could reduce transparency and duplicate work.

The Economic Policy Committee stands ready to develop, in light of the outcome of the special European Council in Lisbon, additional contributions to the reform agenda including concrete targets for further structural reforms.

1 Report by the Ecofin Council to the European Council in Helsinki on economic policy co-ordination: Review of instruments and experience in Stage 3 of EMU.

1. Key messages from the EPC country reviews, 2000

Comprehensive structural improvements are essential to meet our targets of sustainable growth and higher living standards, employment and social inclusion. The special European Council in Lisbon on "Employment, economic reform and social cohesion – towards a Europe of innovation and knowledge" is expected to focus attention on these policies and targets.

Member States have made substantial progress in the implementation of structural reform in recent years, and this has contributed to a better economic performance. Progress has been most pronounced in product and capital markets. Somewhat less progress has been achieved in labour markets, although structural conditions have improved in most countries. However, much remains to be done in all markets. The present good cyclical conditions must not lead to complacency, but reinforce the need to increase the growth and employment potential of our economies. They provide an opportunity to further strengthen structural reform and fiscal consolidation.

Goods and services markets

- Member States have made progress in the transposition of *single market directives*, but more needs to be done, in particular in transport and veterinary checks. Setting up formalised procedures or units to monitor transposition has been helpful in a number of countries. Progress has also been made in opening up *public procurement* to competition, although further efforts are necessary in some Member States.

- Member States have made progress with respect to *reductions of the overall level of state aid* in recent years. This process needs to be continued. Aid should be redirected away from individual firms or sectors towards horizontal goals and should only be granted where it can be justified on economic grounds and provides a clear welfare gain in the common interest, for horizontal purposes such as R&D and the environment.

- Most Member States have reinforced *national competition* laws and brought them closer into line with Community rules. The emphasis should now be on increasing the transparency and the efficiency of monitoring and enforcement. Giving competition authorities more independence and reducing the number of sector-specific regulators by transferring their tasks to the general competition authority has helped in several countries.

- Strong progress has been achieved in *telecommunications* where markets have opened up and competition has been introduced. Consumers have benefited from large price-cuts and a higher quality of services. Efficiency in that sector contributes particularly to the diffusion of ICT and the flow of information and knowledge. Follow-up measures are needed in areas such as networking, e-signatures and e-commerce.

- As regards *other network industries* significant progress has been achieved in the electricity sector though to varying degrees in different Member States. Reform in sectors such as gas, postal services, water and in particular transport needs to be speeded up. Systematic assessment of results in network industries is generally also needed after reforms have been implemented.

- *Privatisation* has proved useful with respect to performance in network as well as in other previously state owned areas. Member States have in particular privatised sectors such as air transport, telecommunications and financial services. Yet, privatisation is not sufficient to create competition, and strong transitory or permanent regulation can be needed in sectors such as electricity to create and maintain efficient competition, while taking due account of public service obligations. Such regulation should be transparent and independent.

- Further efforts are required to promote stronger competition in service sectors such as retail trade and professional services. This is especially true for those services not covered by Single Market Legislation. For example, reducing legal *entry and exit barriers* can improve the functioning of these more sheltered markets. Use of the market to improve the quality and efficiency of public services may also improve the functioning of service markets.

- Most Member States have initiated reforms aimed at *reducing the administrative burden* on enterprises. The use of ICT has been helpful in this respect and has also increased the transparency and quality of government regulation. In a number of countries one-stop shops have eased – or promise to ease - administrative burdens and help stimulate entrepreneurship.

- *Public services* in areas such as education, health and other personal care services account for a large share of Member States' economies. Increasing the efficiency of these sectors to the benefit of consumers and tax payers is an increasingly important issue for the future, especially in view of the challenges stemming from ageing populations. Work is ongoing in a number of countries, though much remains to be learned and done in these areas.

Capital markets

- *The euro has spurred financial market integration*, but it needs to be further pursued. Regulatory and supervisory authorities must adjust the regulatory framework to account for changes in financial market integration and mergers across countries. As a matter of high priority, Member States need to build on the Commission's financial services and risk capital action plans to remove obstacles to a genuine pan-European capital market.

- The development of efficient and liquid *equity markets* is a priority in most Member States. Some merging of equity markets has taken place in response. The privatisation of former state monopolies has, as a side-effect, helped the development of equity markets in a number of countries. The growing size of private pension funds has also contributed to rapid equity market growth.

- Efforts are being made to ensure that there is sufficient access to *risk capital* for SMEs, in particular high-tech businesses, by for example creating equity markets to minimise search costs. However, the private markets for venture capital are developing from a low level. Barriers to the development of venture capital markets also include a lack of those competencies from active investors that are needed by SMEs. The efficiency of financial markets and legislative simplification should be enhanced to support networks of SMEs.

- A number of countries are assisting higher transparency of *corporate governance* through the provision of minimum rules of good conduct, better information and regulation which supports higher responsiveness of management to share-holders.

Labour markets

- Countries differ substantially with respect to labour market developments and policies. In addition, within countries major regional differences exist. Seeking to achieve the *structural conditions needed for higher sustainable employment* in Europe must remain on top of the agenda. There are encouraging signs that EU-wide structural unemployment may have fallen to some extent, as the reduction in unemployment achieved so far has not contributed to higher inflation. In some countries this reduction is substantial. However, most Member States still suffer from a large unemployment problem.

- In a number of Member States skill-shortages and bottlenecks are emerging. Currently, these problems are mainly limited to certain sectors or regions, but they highlight the importance of continued efforts, by governments as well as companies, to *upgrade human capital* through education and life-long learning, not least to ensure that all EU citizens benefit from ICT. It also indicates that some Member States suffer from a lack of regional and non-spatial labour mobility.

- Considerable progress is being made in *active labour market policy* with a stronger focus on earlier preventive measures, human capital formation and the quality of measures in line with the employment guidelines. However, progress is still uneven across countries and regions and further efforts are needed to increase employability and to help the unemployed return quickly to unsubsidised jobs.

- Steps have been taken in many countries to make *tax-benefit systems* more employment-friendly within the limits set by necessary fiscal consolidation and priorities for social protection levels. Measures vary according to country-specific conditions and include lower indirect labour costs, employment-related tax-credits and lower marginal tax rates, especially at the lower end of the wage scale. These measures seek to provide more encouragement and to reduce disincentives to hire and work. A number of countries have undertaken or are planning changes in unemployment benefit systems to tighten eligibility conditions and the enforcement of rules through work tests.

- Increasing competition in product and capital markets may have reduced *insider power* to some extent thus allowing for a higher non-inflationary level of employment for the benefit of those otherwise unemployed. Increasing access to temporary contracts has also helped to create more jobs for new entrants and people at the margins of the labour market in some countries. However, no significant step has been taken to review job-protection rules.

- In most countries *social partners* play a positive and important role, contributing to the implementation of active measures and lifelong learning. The macroeconomic dialogue highlights the social partners' co-responsibility for maintaining favourable employment and price developments and modernising labour markets. In several Member States more progress towards differentiation of wage outcomes is needed.

Policies to promote research and development

- On aggregate the *EU lags behind* the US and Japan in terms of R&D expenditures and, especially its innovative capacity. Large differences between member states also exist. All member states are pursuing policies to promote R&D.

- Improving human capital formation, and in particular addressing the *insufficient number of scientists and engineers,* is important in most countries. The efficiency of R&D and the diffusion of knowledge need to be further improved by investing in the *communications infrastructure*, the *diffusion of knowledge*, networks, and *co-operation* between public and private institutions both at the national and at the EU-level. The development of *financial markets* is also important, cf. above.

- Creating a *more competitive environment* strengthens the incentives for firms to innovate and enables a more rapid diffusion of technology and information. The evidence confirms that raising the level of competition in product and capital markets promotes product and process innovation and, in particular, the diffusion of innovation. Legislation that ensures the appropriate protection of intellectual property rights is also required to enable private enterprises to develop their R&D activities.

- Some countries also give *direct support or tax credits* for R&D expenditure. Private enterprises, especially SMEs, may in the absence of public support devote too few resources to R&D, leaving positive externalities unexploited. Public support to address this externality problem should be as neutral as possible to avoid scarce human resources being allocated from other productive tasks. The EPC is about to produce an opinion on policies to promote R&D.

- In order to make R&D policies more effective and better targeted across Europe action for promoting research networks at the national and European level should be strengthened.

Policies to cope with the challenge of ageing populations

- In all Member States the ageing of populations provides a *long-term challenge for public finances*. The EPC has established a working group to analyse this issue.

- Many Member States have started to take measures to tackle the issue by: a) pursuing further *fiscal consolidation*, in some cases including the establishment of reserve funds b) introducing measures to stimulate *higher labour force participation*, especially for older workers and c) *reforming pension systems* with respect to benefits and contributions.

- Most Member States *still need to develop comprehensive strategies* to address the issue of ageing populations, including higher efficiency of health and other care sectors.

Work on structural performance indicators

The assessment of progress in all areas of structural reforms has benefited from the high quality of reports from the Commission and Member States on progress in policies and indicators of structural performance. These efforts need to be developed even further. The EPC is ready to continue its work on structural performance indicators that might be used for assessing the efficiency of European markets and the effectiveness of policy measures.

Implementing the Broad Economic Policy Guidelines

- The country reviews included an assessment of the implementation of the country specific recommendations given in the *1999 Broad Economic Policy Guidelines*. Taking all fifteen Member States as a whole, most country-specific recommendations have been at least partially implemented. Nevertheless, the degree of implementation varies between policy areas and Member States.

- Progress in implementing the guidelines has been strongest in areas such as: *Single Market Legislation, telecommunications and electricity markets, part-time work, and preventive approaches to youth and long-term unemployment*.

- Progress has been weaker in areas such as: *public procurement rules, transport, water, gas and postal sectors, retail outlets, risk capital markets, benefit systems and reviewing employment protection legislation*.

2. The need for structural reform

2.1. European structural policies in perspective

Citizens of the European Union enjoy on average high living standards and social protection levels. However, major challenges and opportunities for economic and structural policies exist due to:

- The unexploited potential for higher productivity and living standards as demonstrated by the large differences between countries, between regions and between the most advanced and weaker sectors.
- High unemployment and low labour force participation rates in many countries and regions.
- Problems with respect to social inclusion.

Another challenge is to adapt to increasing globalisation, new technologies and the emerging knowledge-based economy. Economic structures regularly need adjustments to realise fully this potential. Policies must provide a framework within which economies can make fast and positive responses to change.

Macroeconomic shocks and misguided policies, especially loose and pro-cyclical fiscal policies in the 1970s and 1980s, contributed to adverse developments. Since then macroeconomic policies, reinforced by the EMU convergence process, have improved strongly with respect to fiscal consolidation and low and stable inflation. The introduction of the euro as the single currency contributes also to stability. It prevents adverse exchange rate pressures within the euro zone and has cut the level and fluctuations of risk premiums.

To a large extent problems with respect to labour markets and inadequate productivity are structural. They require structural reforms that raise the potential within which growth and employment can develop without creating inflationary pressures. Thereby, Europe can catch up with the recent strong performance of other regions such as the USA.

The EU response to these structural challenges has been to:

- Pursue further integration of markets and raise competition by developing the Single Market, reinforced by the introduction of the euro.
- Establish at the EU-level learning and implementation processes of benchmarking, good practices and peer pressure in other areas of structural policies.
- Seek dialogue and mutual understanding with the social partners.

These policies and positive macroeconomic figures are not targets in their own respect. They are means to achieve higher living standards and employment, better social inclusion and an economy which can afford high levels of social protection and protection of the environment.

Many of the steps taken in favour of improved policy co-ordination are recent and the full benefit will only materialise over a longer time horizon. However, an indication of favourable developments and better economic integration is provided by the catching up of the least advanced countries during the 1990s, whereas very little catching-up took place in the 1980s, *cf. figure 2.1*.

Figure 2.1a. Productivity, 1980s.

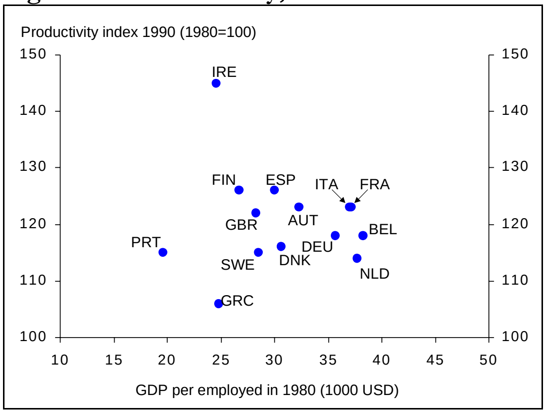
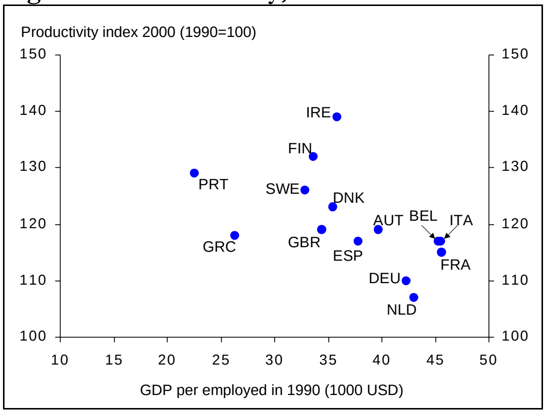


Figure 2.1b. Productivity, 1990s.



Note: The productivity index reflects developments in GDP per employed for the total economy. GDP is measured at purchasing power parities (PPP).
Source: OECD Economic Outlook No. 66.

2.2. Progress in recent years and challenges in the near future

The EU-economy has developed favourably over the second half of the 1990s with continuous growth in GDP and increasing employment, *cf. table 2.1*. Productivity growth has not been strong, but this may to some extent reflect a larger take up of jobs by the low skilled with productivity less than the average. As such a shift in the composition of employment may reduce structural unemployment it can cause a sustainable improvement in both growth and total employment.

Table 2.1. Growth performance in recent years. EU-15.

	1995	1996	1997	1998	1999
Productivity [1]	1.9	1.7	1.7	1.3	0.9
Employment	0.6	0.1	0.8	1.3	1.2
GDP...	2.5	1.8	2.5	2.6	2.1

1) GDP per person employed. Total economy.
Source: Commission Services.

The combined achievement of higher employment, lower unemployment and non-inflationary wage-developments in recent years provides a rough indication of structural improvements, *cf. figure 2.2*. The pickup of price inflation in 1999 from a very low level was on average due to a turnaround in import prices and not domestic developments in the EU.

Figure 2.2a. The labour market. EU-15.

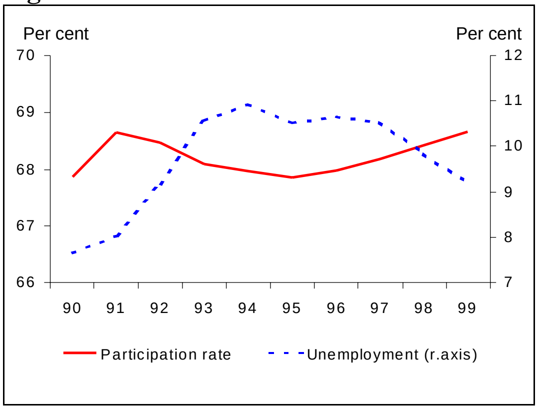
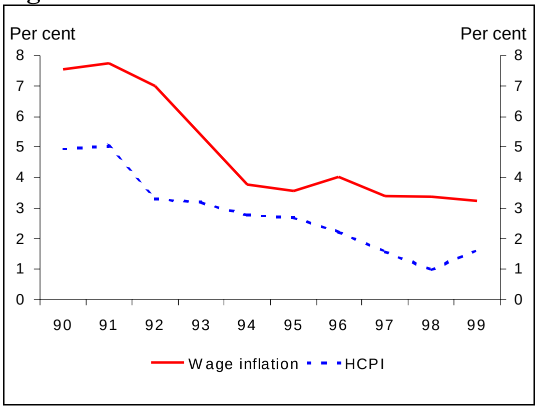


Figure 2.2b. Inflation. EU-15.



Source: Commission Services. OECD, *Economic Outlook No. 66.*

Other signs of structural improvements take the form of higher productivity and falling prices in the sectors where reforms are most advanced. Those countries, which are well advanced with structural reforms, have in general a better performance with respect to growth and, in particular, employment.

Together with the creation of the euro, the reforms have increased the capacity of our economies to adjust and cope with external economic disturbances. As an example the Asian crisis may have had more adverse effects on EU growth and employment in the absence of this.

In all countries further structural reform will raise the sustainable growth rate and the level of employment compatible with low inflation. Enhancing the productive potential in those countries approaching capacity constraints will ease the need for restrictive macroeconomic policies for the area as a whole contributing to growth in other economies. Further fiscal consolidation will also help to alleviate inflationary pressures, enhance the potential of fiscal policy to ease forthcoming cyclical setbacks and contribute to the preparation of the long-term challenge of ageing populations.

There is some risk of pro-cyclical fiscal policies in a number of Member States as budget positions improve. Growth dividends only increase the room for manoeuvre in fiscal policy to the extent that they reflect sustainable improvements in the productive potential and an underlying budget position which provide a buffer in future downturns.

In one group of countries, *Denmark, Ireland, the Netherlands, Portugal and the UK*, the business cycle and labour market reform is advanced and unemployment has fallen strongly to low levels, which may not fall much further. *Austria and Luxembourg* have maintained low levels of unemployment.

Another group of countries, *Finland, Spain and to some extent Sweden*, has also experienced strong growth and reductions in unemployment but faces unemployment problems at a higher level.

The countries belonging to either of these two groups need both to dampen demand growth and continue to increase the potential for growth and employment. Labour market reform will be the key to rolling back structural unemployment in the second group, whereas measures to increase labour supply are especially required in the first group.

A third group of countries, *Belgium, France, Germany, Greece and Italy,* has high and mostly structural unemployment levels but somewhat more cyclical room for manoeuvre, even if they differ with respect to the current rate of increase in employment and progress in structural reform. Belgium, France and Greece and to some extent Italy have had fairly strong employment growth in recent years.

In these countries structural reform has up to now mainly focused on stimulating the demand for labour, especially in Belgium and France where strong reductions of indirect labour costs for low earners have taken place. By providing new job opportunities for those being affected by unemployment, this may in turn increase the effective labour supply and thereby reduce the level of structural unemployment. In Italy, the developments were supported by measures such as the introduction of new and more flexible job contracts aimed at improving the supply side. Yet as economic activity and employment improve further structural policies in these countries need to focus more urgently on enhancing the supply of labour. Such measures take time to implement and produce results.

2.3. Challenges in the longer term

Ageing populations is another challenge to be addressed by careful fiscal policies and prudent structural measures to increase growth and employment.

The challenge of ageing populations includes pension expenditures as well as services for health and long-term care. In all countries an increased focus on raising the productivity in these sectors will help to alleviate the pressure on public finances.

Reviewing not only the sustainability but also the quality of public finances is a very important structural issue. Government spending should be targeted at future oriented tasks such as investment in human capital, infrastructure and active measures to reduce structural unemployment. Tax and benefit systems should in particular minimise the pressures that may discourage hiring and working.

Improving the framework conditions for competition and the introduction of new technologies are important in all countries. Some Member States also need to overcome historical under-investment in education systems and human capital formation within the longer time-span needed for such developments. Progress has been experienced in most countries in this respect.

2.4. Fairness and social inclusion

European social models, though somewhat different, all seek relatively high social protection levels and social cohesion. This is by no means only achieved by providing income support. Combating social exclusion requires a comprehensive approach, which must ensure upgrading of skills, equal access to labour markets for all, access to health and care services and include measures aimed more directly at those individuals in danger of being excluded.

Creating generally better framework conditions for high employment and low unemployment is the strongest contribution structural reforms can make to social inclusion. Weak labour market conditions always hamper the position of vulnerable groups.

Supportive and targeted active measures are also very important. They offer new chances for people at the fringe of the labour market and encourage continuous efforts to enter or re-enter employment.

Globalisation and new technologies are thought by some to weaken the position of the low-skilled and vulnerable groups. Improving the positions of these groups is an ongoing challenge, but globalisation and new technologies also provide, if wisely handled, opportunities for the vulnerable groups.

Many countries, including some in Europe, have experienced strong employment increases during the 1990s, which have also benefited vulnerable groups. The dis-inflationary impact of new technologies and increased competition has contributed to these achievements. Insider power might have diminished as a result of the stronger competitive pressures to the benefit of outsiders. As ICT is being developed and experience is gained the focus may shift from the demand for high-skilled software developers to widespread use of user-friendly programmes in all sectors of the economy.

Existing mismatches on the labour market require continuous efforts to enhance human capital, especially in basic and secondary education, bringing the supply of skills more closely into line with demand. Improvements in the overall skill level will also contribute to reducing the excess supply of low-skilled labour. What matters in particular is the ability of economies and the labour force to adapt to change. Encouraging life-long learning of the work force becomes essential in this respect.

3. Progress in structural reform

This chapter focuses on progress in structural reform, i.e. actions, initiatives and measures taken to improve the functioning of national as well as European product, capital and labour markets, including the two special topics on policies to promote R&D and the sustainability of public finances in relation to ageing. Given the focus on progress, particular attention is paid to measures introduced within the last few years, and to measures that are planned or considered for implementation during 2000.

It must therefore be emphasised that even if progress may appear limited in an area in a particular Member State, this may reflect the fact that the particular country is already performing well in that particular area. Similarly, the reason for other Member States' apparently fast progress in an area may reflect a weaker starting point.

However, those Member States that have advanced the most with structural reforms are mentioned throughout the text. Moreover, it should be noted that the text mentions a lot more examples of good structural reforms than those that have been singled out in seven good practice boxes, covering different areas of structural reform.

3.1. Markets for goods and services

Strengthening of the Internal Market

The process of creating unified European product and capital markets characterised by competition is well underway. Effective monitoring and continued evaluation of the performance of the Internal Market, through the Single Market Scoreboard and the annual review of the Commission's Strategy for the Internal Market, is essential to the success of economic reform measures.

All Member States are making *substantial efforts as regards transposing Internal Market Directives* into national law. According to the Single Market Scoreboard, a majority of Member States and Italy and Belgium in particular have reduced their backlog significantly during 1999. Yet the non-transposition rate increased in some countries, and the backlog is still notable in a number of countries. By November 1999, more than 5 per cent of the Internal Market Directives had not been transposed by France, Greece and Luxembourg. Accounting for the total number of directives, the non-transposition rate is generally highest for directives related to transport, telecommunications, public procurement and veterinary checks.

To strengthen the Internal Market, Member States need to make a full, timely and correct transposition of Community legislation, and to effectively apply and enforce existing legislation. In this respect the Commission's monitoring role is important, in particular its responsibility to act rapidly and effectively against infringements. However, Member States should develop national strategies to ensure an efficient transposition of Internal Market Directives into national law. Several Member States have recently established *specific co-ordinating units or formalised procedures*. The Netherlands created the Interdepartmental Committee on EU Law in 1997, and Germany, Ireland and the UK have in 1999 taken steps to strengthen their procedures. Belgium will soon appoint a commissioner to handle the implementation of all directives, while the Walloon government will create a European Directives Transposition Task Force.

Although the rate of non-transposition has generally been reduced in recent years, a number of Member States have highlighted some specific aspects of the functioning of the

Internal Market. Denmark, Sweden and the UK mention that technical barriers and a lack of mutual recognition are often encountered. Along with other Member States they emphasise the importance of the "new approach" to technical standards. It is important to avoid the appearance of new technical barriers to trade. This demands a more rigorous application of the notification procedures foreseen in Community law concerning national initiatives for the establishment of technical standards or regulation. Finally, many Member States encourage the Commission to look into the issue of liberalising parallel imports from countries outside the EEA.

Responding to companies that had experienced infringements of the Internal Market legislation, the Netherlands made it possible for Dutch companies to make complaints to the Competition Authority in 1997. This service was extended in 1999 to cover foreign companies' complaints over infringements experienced in Dutch markets. The Danish Competition Authority established a similar service in 1999.

Public procurement comprises a significant part of total demand and may as such play an important role in enhancing competition in product markets. Yet the value of European calls for tender through the Official Journal still only constitutes a relatively small share of estimated total public procurement, approximately 13 per cent in 1998. A number of Member States have a backlog with regards to the transposition of Internal Market Directives in this area, but they are making efforts to correct this, in particular Germany and Greece.

At the same time, several Member States are engaged in initiatives to issue guidelines, which simplify procedures and institute formal procedures. Special attention should be paid to the Pilot Project on Public Procurement involving six Member States, Denmark, Germany, Italy, the Netherlands, Spain and the UK. They are co-operating to provide assistance to firms experiencing barriers when participating in EU calls for tenders in these countries.

New information technology may play an important role in providing companies with easy access to the details of *calls for tender*, as emphasised by many Member States. The Netherlands have, for example, defined a Professional Purchasing and Procurement Action Plan which aims at making all details of EU procurements available electronically within the next two years. France and the UK mention similar initiatives.

To strengthen competitive public procurement, Germany has recently *increased the possibility for legal appeal* by private companies against discriminatory practices by government authorities. The Danish Complaints Board will be given powers to fine public authorities infringing tendering rules.

Some Member States note a number of more fundamental problems concerning public procurement in their national reports. Despite having a lower threshold for competitive tendering than required by the Directive, Finland has experienced very little interest from foreign companies in submitting offers. The Netherlands mentions the inherent disadvantage of SMEs in participating in the competition for large orders, although the use of the Internet may facilitate increased SME participation due to lower costs. Some Member States have experienced difficulties in extending competitive tendering to regional or local authorities. Finally, it was argued that the EU regime for public procurement must be updated to provide simpler and more flexible rules within a clear legal framework, while preserving its fundamental stability.

Competition policy and state aid

- Competition legislation
- State aid

Competition legislation

In Member States there is a growing political will to strengthen competition. Several Member States have increased the efficiency and transparency of procedures and enhanced the powers and means of competition authorities. Thus, the *modernisation and convergence of national competition laws* is continuing, bringing them closer in line with EU competition laws. During the last year Austria, Belgium, Germany, Spain and the UK have amended or made substantial changes to their national competition laws. As a result, the competition laws of most Member States will be based on the *principle of prohibition* of anti-competitive practices, enabling the competition authorities to enforce Article 81 (cartels) and Article 82 (abuse of dominant position).

However, *the two articles are not yet implemented in the national legislation of six Member States.* Denmark expects a new competition law proposal to be put before parliament in 2000, which will give the competition authority the powers to enforce Article 81 (cartels) and Article 82 (abuse of dominant) position. Luxembourg has completed a study concerning the adaptation of EU competition laws and is currently preparing a proposal. Ireland and Sweden are currently reviewing their competition laws with respect to the two articles, whereas Finland and Portugal have put further reform on hold until the details of the Commission White Paper have been clarified.

Merger control is an important issue in several Member States. In many countries, competition authorities already have the power to control mergers. As part of the new competition laws in Spain prior notification of mergers above certain thresholds became compulsory. Moving from a system of voluntary notification, this change implies a significant strengthening of the powers of the Spanish competition authority given the current wave of mergers. Greece has introduced legislation requiring prior notification of all mergers and acquisitions in the banking sector. Sweden has proposed a bill to simplify merger controls, and the UK is reviewing its laws relating to merger control. Belgium and Germany abolished the requirement of notification for small mergers in 1999, the idea being to focus on economically important mergers and raising the efficiency of the competition authorities.

Establishing the right legal framework is only a necessary condition for promoting effective competition. The beneficial effects on competition will only materialise if competition rules are actually enforced efficiently. This requires that the competition authorities are allowed to engage in *effective enforcement* and are equipped with the necessary means to do so. In, for example, Belgium, France, Spain and the UK resources of the competition authorities have been increased, and Denmark and the UK will give them powers to fine companies that abuse competition laws.

There is also a significant *trend towards granting complete independence* to competition authorities, although the importance of this is not fully endorsed by all Member States. The new Competition Commission in the UK will be more autonomous than the previous Monopolies and Mergers Commission. Austria and the Netherlands are expecting that the forthcoming revision of competition legislation will grant full independence to the Competition Authorities.

State aid

The *overall level of state aid is gradually being reduced* in all Member States, although temporary setbacks have been observed in a few countries in recent years. From 1990-92, state aid in the EU-12 fell from 1.8 to 1.2 per cent of GDP in 1995-97, when excluding agriculture. Moreover, *state aid is being restructured* so that the relative importance of sector-specific and ad hoc aid is falling, while the level of horizontal aid appears to have been maintained or even increased in a large number of Member States.

Despite the overall positive trend sector-specific aid is still significant in some countries. *Much aid is devoted to the transport sector* in many countries, and some countries still provide support for the coal, textile and shipbuilding industries as well as the financial sector. Even if this form of aid is being phased out, it might be *advantageous to proceed faster*. Not only may sector-specific aid distort competition at the European level, it may also delay inevitable economic restructuring. Freeing resources from industries in decline is particularly important in the current situation where many Member States are producing close to capacity.

More efforts should also be made to monitor the overall level of state aid, to evaluate its economic effects and to identify those classes of state aid that are particularly distorting. The Commission should pursue vigorous action against state aid which is particularly damaging to competition. Horizontal state aid aimed at for example promoting R&D and improving the environment may be justified due to market failures.

Regulatory Reform

- Privatisation
- Liberalisation of telecommunications
- Opening of energy markets
- Progress in other public utilities
- Service sectors with low and restricted competition
- Improving the efficiency and quality of public services

The direct state involvement in the production of goods and services still varies considerably between Member States. In the past, the public sector assumed the responsibility for producing and providing a wide range of product and services based on considerations of what would be in the public interest. Over the past decades, however, the *role of the public sector has been significantly reconsidered*. While paying due respect to public sector obligations, it has been recognised that the public sector does not necessarily have to be directly involved in production. Increased cross-border competition and technological developments explain much of this change of direction.

Member States are increasingly recognising the importance of the quality and the range of commodities and services they make available to citizens. It is becoming less important who is the producer as long as production is efficient and satisfies the desired targets.

Based on this analysis, it is possible to identify *three overall trends, which are redefining the boundary between the private and public sectors*. First, direct public sector involvement is being rolled back completely in sectors such as air transport and financial services where public service obligations can be satisfied through regulation without requiring direct public ownership. Second, in sectors such as network-industries activities are being unbundled so that direct state control or detailed regulatory intervention is only maintained for those parts of the services where competition is not possible. Third, in areas where public service obligations are important a wide range of initiatives is being tested in Member States to increase the focus on output and ensure cost effectiveness in the provision of these services.

Privatisation

Privatisation of public companies serves several purposes, but is foremost *a means for improving efficiency and the quality of services*. But privatisation of public monopolies needs to be accompanied by simultaneous efforts to enhance competition. Simply turning a public monopoly into a private monopoly may lead to a worse outcome.

Some Member States already have relatively low levels of state ownership, while *others have embarked on extensive privatisation programmes* in recent years. Privatisation has progressed furthest within sectors, where public service obligations are limited or can be achieved by appropriate regulation of the private sector. Spain will complete the full privatisation of its national airline fully during 2000, while Greece and Portugal are in the process of a partial privatisation of their national airlines. In 1999, Germany privatised a number of airports.

Similarly, *financial institutions are being privatised* in several Member States. Greece is moving out of the banking sector, while France has sold all its shares in Credit Lyonnais. A decision has also been made in Ireland to withdraw completely from the financial sector, and it is currently considering how the two remaining state banks can best be privatised.

As telecommunication markets have become more competitive, the need for direct state involvement has vanished. Consequently, Ireland completely privatised its telecommunications company, while Finland and Greece reduced state holdings in 1999. Further privatisation in the telecommunications sector is also expected in Germany during 2000.

In the *energy sectors, privatisation is also taking place* more or less simultaneously with ongoing market opening. For example, having opened the electricity market to competition Spain completed an almost full privatisation of the electricity network in 1999, while Italy floated almost one third of the share capital of the dominant electricity company.

Liberalisation of telecommunications

All Member States have in recent years achieved large gains from the liberalisation of the telecommunications sector. Helped by technological progress in especially mobile telephony, *prices have fallen significantly* for most kinds of fixed line and mobile calls, benefiting large as well as small customers.

Full liberalisation has been achieved for several years in Finland and the UK, and during the past two years full liberalisation of telecommunications or progress towards it has been most rapid in Denmark, Germany, Spain and Sweden. In most other Member States, the process is well advanced, but further measures are still required to bring national legislation in accordance with EU directives. Further progress may also be needed with regards to strengthening the regulatory authorities and enhancing regulatory transparency in a number of Member States. For example, in some countries concern has been expressed about whether the regulatory authorities have sufficient independence and are strong enough to ensure access on equal terms for new operators.

Table 3.1. Progress in regulatory reform of public utilities.

Telecommunications	Liberalisation and privatisation are well underway in all Member States, although some still lack competition in local fixed telephony. The next step is to ensure that the regulation of telecommunications facilitates the diffusion and use of ICT, inter alia through exerting downward pressure on prices.
Electricity	The frontrunners among the Member States already have competitive markets, and the remaining are following suit. The next step is to create a Single Market for power.
Gas	Most Member States are in the process of transposing the Gas Directive, preparing for the partial market opening due in August 2000.
Water	Little progress reported.
Railways	Separation of infrastructure and management in many Member States as a first step towards liberalisation. Only a few Member States have started on actual liberalisation.
Road transport	Liberalisation of road haulage in a number of Member States following the EU Directives. Local bus transport contracted out in a few Member States.
Postal services	A few Member States have reported progress, but generally modest.

Yet the *importance of telecommunications liberalisation goes much beyond securing lower prices on voice telephony*. The infrastructure of telecommunications will play a vital role in the creation of the e-society. Today, there is already a clear trend towards the merger of all media for the transmission of digital information. Liberalising telecommunications is therefore only the first step towards a more comprehensive regulatory approach to the digital society. The Netherlands mentions this challenge in their national report.

Opening of energy markets

Liberalisation of energy markets is proceeding well. Almost all Member States managed to open electricity markets by the 1999-deadline set by the Directive. In Luxembourg implementation of the Directive is delayed, while Ireland in 1999 established an independent regulator to prepare for market opening by 1 February 2000. Greece has a derogation and will open the electricity market in 2001. It has in the meantime prepared the legislative framework for the establishment of an independent regulator for the energy market. With respect to the gas market most Member States are currently preparing the necessary legislation in order to meet the deadline of 10 August 2000 for transposing the Gas Directive. Greece and Portugal have received a derogation due to the immaturity of their gas markets.

Yet there are *pronounced differences as regards how much and how quickly electricity and gas markets will be opened*. In Finland, Germany, Sweden and the UK electricity markets are already completely liberalised. Denmark, Italy, the Netherlands and Spain are opening electricity markets faster than required by the Directive, giving all customers free access within a relatively short time span. In gas markets, Austria's draft law provides for a complete market opening by August 2000, and Italy is also planning for a relatively fast market opening.

Those Member States that are now opening energy markets should pay attention to the front runners in energy liberalisation. The UK has had competitive electricity and gas markets for a number of years, and the electricity markets of Sweden and Finland have also been completely opened. *Much is to be learnt from the experiences of these countries.*

First, encouragement to proceed with liberalisation is to be found in the *benefits in terms of lower energy prices*. Those Member States who have opted for an approach of a very gradual opening up of markets might therefore want to consider speeding up the process.

Second, the transposition of EU-directives will generally not be enough to ensure competitive markets. *Further measures are required* in terms of regulation, restructuring and controlling the market power of the incumbent. It is, for example, crucial to ensure that market access is not hampered by the high costs of switching between suppliers. To that end, Sweden changed the requirements for electricity metering equipment for small customers in November last year.

Third, it must also be recognised that giving third party access to networks is only the first step towards creating fully competitive energy markets at the national as well as the European level. The next step may be to *ensure that exchanges are created where energy can be traded* on spot markets and on future contracts. The UK has such markets for both electricity and natural gas. An electricity exchange is established in Spain, while Germany has created electricity exchanges in Frankfurt and Leipzig, which are supposed to start operation in 2000. But the target must ultimately be the establishment of markets open to all Member States. The Nordic electricity exchange, NordPool, is the first international market place for electricity trade, cf. *box 3.1*.

Box 3.1. Good Practice: Electricity liberalisation and electricity exchanges.

By 2001, all Member States will have opened their electricity markets to competition to the extent required by the EU directive. Yet many Member States have already decided to open their markets faster than the minimum requirements of the directive. Electricity markets are already completely liberalised in Finland, Germany, Sweden and the UK, and Denmark, Italy, the Netherlands and Spain will give all customers free access within a relatively short time span.

The potential benefits for consumers are considerable. For example, Eurostat data shows that Swedish electricity prices (before tax) in 1999 were around 60 per cent of the EU average for industrial user and 70 to 90 per cent for households. A study by DRI Europe for the Commission estimates that the liberalisation of electricity markets had increased GDP by around one third of a per cent in Sweden and the UK in 1999 compared with a hypothetical case of no liberalisation.

The opening of national markets for electricity is only an important step on the road towards an internal European market for electricity characterised by competition. A truly European market requires the establishment of exchanges for trading electrical power.

NordPool, the Nordic Power Exchange, is the only international exchange for trading electricity in the world. It was established in 1996 by the national grid companies in Sweden and Norway, following the liberalisation of electricity markets in these countries. The Finnish grid company became associated with NordPool in 1997, while the grid company of Western Denmark joined in mid-1999. The grid company of Eastern Denmark is supposed to join shortly.

NordPool offers a number of products and services: Elspot - offers trade in power contracts for physical delivery during the next 24-hour period. Eltermin – is a financial market for price hedging, risk management, and trade in forward and future contracts. Eloption – allows for trade in power options and was introduced in 1999. Clearing – offers an opportunity for reducing counterpart risks in bilateral electricity trade in Europe

The turnover of Nordpool has been increasing rapidly. A total of 75 TWh was traded on the spot market in 1999, corresponding to an increase of 34 per cent relative to 1998. The physical deliveries corresponds to more than 20 per cent of the consumption of electrical power in the Nordic countries. Trade on the market for financial power contracts increased by more than 140 per cent in 1999, reaching a level of 216 TWh. By the end of 1999, more than 250 companies participated in NordPool trading. Most of them were Nordic, but a few companies from Germany, the Netherlands and the UK were also active in the market.

Recently, Nordpool has become involved with German partners in the creation of the first German electricity exchange in Leipzig, which together with another electricity exchange in Frankfurt is supposed to start operations in 2000. This represents another step forward in the creation of a pan-European market for electricity.

Since the network services, which are part of the supply of energy, will still be a monopoly, liberalisation does not render regulation obsolete. On the contrary, regulation may be even more important in markets which are in transition to full competition. There is a pronounced risk that those companies supplying captive customers will engage in discriminatory practices to give them a competitive advantage towards non-captive customers. This raises the issue of which regulatory practice to use when setting tariffs for the use of networks and prices for captive customers. The UK has decided to use RPI-X regulation, i.e. setting increases in tariffs equal to a price index (RPI) less a rate of efficiency gains (X). This regulation gives incentives for service providers to improve efficiency as they are allowed to keep any profits. From the point of view of the regulator, the key issue is to ensure that the required efficiency gains are both challenging and realistic.

Many of the points made for energy networks will also be relevant for other markets less advanced in the liberalisation process.

Progress in other public utilities

Progress in other sectors, where the public sector has traditionally played a substantial role, is more patchy and moderate. Railways still receive substantial state aid in many Member States, despite the falling trend, and public monopolies dominate completely in most countries. Most effort is therefore currently being put into *improving the efficiency of railways.* Separation of infrastructure from operation, either in the accounts or by creating separate entities, has taken place in most Member States. Moreover, the strengthening of management capabilities is high on the agenda in many countries.

Only the UK has liberalised railway services, but is on the other hand suffering from poor quality of the infrastructure and passenger services. To correct this, an Infrastructure Investment Fund has been established, which over the coming year will be allocated substantial public funds and may take part in Public-Private Partnerships. Private enterprises are also engaged in supplying railway services in Sweden, and Germany has started to introduce competition into regional passenger services. In Austria, a new law came into force on 1 January 2000 which will provide for efficient and non-discriminatory market access for railways. In addition, it will in accordance with the EU directive be possible, subject to certain preconditions, for every railway company with its head office in Austria to obtain a franchise which is valid throughout Europe. Other *Member States intend to open the market for both passenger and freight services* within the next few years, yet some of the national reports are not very optimistic about the degree of private sector interest in running such services.

In *road transport*, road haulage was further liberalised in Belgium, Germany and Spain in 1999, bringing their regulations into line with EU law. Otherwise, little progress has been reported. Much the same can be said with regard to developments within the air transport sector and postal services, although some Member States, including Austria, have recently liberalised ground-handling in airports in accordance with EU legislation.

Service sectors with low and restricted competition

Despite the creation of the Internal Market and efforts to strengthen national competition, several Member States observe *a lack of competition in some service sectors*, private as well as public. These are largely sheltered from foreign competition and influenced by various kinds of national regulation. Many Member States have achieved progress in increasing competition in predominantly private markets, but additional efforts are required. The functioning of services markets can be improved through adjustments of the regulatory framework with the aim of lowering entry and exit barriers and increasing competitive pressure.

The Netherlands has initiated a systematic approach to increase the level of competition in more sheltered markets. The MDW process is thus designed to remove barriers preventing access to markets (M), to reduce unnecessary burdensome regulation (D) and improve the quality and transparency of legislation (W). Recently the government has put increased focus on evaluating the costs and benefits of MDW projects and on implementing the results of MDW-evaluations.

Retail distribution is still in many Member States subject to restrictions in the form of *land use planning and limitations on shop-opening hours*. Italy initiated a comprehensive reform in 1998, abolishing the licensing system for small retailers and the registration of shopkeepers. The result has been a significant restructuring of the sector as there has been a rise in the establishment of new outlets, while a number of small retailers have closed down. Regulation of shop opening hours is under review in Denmark and Germany, while the Netherlands and Sweden are looking into the effects of spatial planning on competition in the retail sector. Portugal is reviewing Sunday opening hours for large-scale commercial units, while providing support for small retailer associations to establish online links with customers.

Most Member States are making significant strides towards supporting an *increased use of e-commerce*, which will undoubtedly increase competitive pressures in part of the economy. Efforts are being made to ensure that the necessary legal framework is in place, including legislation on the validity of electronic signatures.

Various Member States have introduced a range of measures to enhance competition in specific areas. Germany has allowed lawyers, accountants and tax advisers to set up firms. Ireland has taken action to increase the number of licences for Dublin taxies, and the UK is reviewing the current exemptions for professional bodies in relation to the competition law.

Improving the efficiency and quality of public services

However, the role of the *public sector is also crucial when considering sheltered service markets*. Exposing the public sector to competition may be a means to improve the efficiency and quality of public services. A systematic approach to the regulatory framework for services could aim at identifying areas where market elements could be used in the provision of public services, and where an increased use of private service provision would be preferable to existing public provisions. Such a shift from public to private provision is already underway in network utilities, and the process of privatisation is another example recognising that public ownership is not necessarily required to ensure the provision of certain services.

It is particularly important to ensure a level playing field between private firms and organisations with exclusive links to the government, which could give them an unfair advantage. The Dutch "Market and government" programme is addressing this issue. The present government intends to draft integrated legislation governing all sectors, the aim being to create a uniform system of standards and appeals procedures for those who may be disadvantaged by such activities.

While short on concrete measures, Member States put much emphasis on the need to improve the efficiency and quality of public services. Given the need for continued fiscal consolidation and the financing requirement for ageing populations, enhanced efficiency remains a crucial means for meeting the increasing demand for public services. This should be one area of future work, but until now little can be learned from bench marking and good practice comparisons.

Spain has in 1999 introduced new *management contracts* within the health sector, and Greece is more generally trying to improve the performance of public sector entities by strengthening management and management contracts. The aim of these contracts is to clarify the objectives of public service producers by specifying outputs in terms of quantity as well as quality, whilst giving the producers more autonomy and flexibility.

A number of Member States, including Finland and the Netherlands, are experimenting on a limited scale with various ways of *introducing competition into the production of public services* in areas such as health, child and personal care as well as in education, *cf. box 3.2.*

Box 3.2. Good Practice: Policies to improve the efficiency of the public sector.

Finland, the Netherlands and Sweden have experimented on a limited scale with ways of introducing competition into the provision of public services.

In Finland, the KILPA project examined the use of a service voucher system in the provision of care services, health care and education. The aim was to achieve better cost efficiency, quality and a customer-oriented approach. One area where this system was used was in child day-care provision. A follow-up report on these services indicates that alternative day care is very competitive both in quality and in price and clearly more economical than municipal day care services. Given the generally positive first experiences the Government Programme now provides for expanded use of the service voucher system through field trials.

In Sweden, the exposure of the public sector to competition, for example through public procurement, has increased the proportion of privately run services in the core activities of municipalities such as day nurseries and nursing homes.

Public-Private Partnerships (PPP) are one way of increasing the role of the private sector that may help to ensure efficient and competitive production and achieve a more efficient allocation of risk between the public and private sectors. Recently, PPPs have been applied successfully to large-scale infrastructure projects in Portugal, Sweden and Greece, where further use is also planned. Ireland, the Netherlands and the UK are considering future use of PPPs for infrastructure projects, whereas PPPs are planned to modernise the federal administration's computer system and to promote the Internet in, respectively, Belgium and Austria. PPPs may be extended to other areas, yet the comparative advantages of the public and private sectors need to be identified, and efforts to do so are being made in the UK.

Moreover, several Member States have stated an intention to explore under which circumstances, partnerships with the private sector can be appropriate and advantageous. Ensuring a high degree of transparency will be important if PPPs are going to be a successful as a means of introducing competition in markets, which cannot immediately be liberalised. However, PPPs should not aim at replacing the traditional approach of opening markets to competition including privatisation where appropriate.

Improving the business environment

- Measures to reduce administrative burdens
- Promoting start-ups and SMEs

In competitive and dynamic markets, the creation of new enterprises limits the possibilities of incumbent firms to engage in non-competitive practices. In addition, new enterprises are often a source of innovation, particularly in new high-tech sectors. It must therefore be ensured that starting a business is made as simple as possible.

Efforts to improve the general quality and transparency of government regulation are in a broader context central to facilitating a smooth interaction between the public sector, on the one hand, and enterprises as well as citizens on the other. Excessive or poor regulation not only implies that resources are wasted by the private sector, it may also create an environment prone to circumvention and mistrust towards public authorities.

Measures to reduce administrative burdens

Increasing transparency in the regulatory process, notably through impact assessment which evaluates the economic and administrative burden on business, needs to be integrated into the legislative process at community and national level. Non-regulatory alternatives should be considered and special account taken of the impact on small and medium-sized enterprises.

Many Member States such as Belgium, Ireland, the Netherlands, Spain and the UK have established specialised units or projects within government with the task of *ensuring regulatory quality and transparency*. Others have established formalised procedures aimed at ensuring that all new legislation is subject to quality checks.

Focusing more on businesses, Austria has recently established the Advisory Commercial Law Committee, Ireland the Small Business Forum, Sweden the SimpLex group, Germany a working party and Denmark various business panels. The purpose of these initiatives is to *exploit the experiences of the private sector, in particular SMEs,* when drafting new legislation, ensuring the highest degree of simplification and transparency. At the Community level, initiatives have also been taken to simplify the legislative framework, for example SLIM, BEST and Business Test Panels.

To provide small enterprises and citizens with *easy access to public entities*, Italy, Portugal and Spain have already in 1999 established one-stop-shops and more will be opened in the near future, *cf. box 3.3*. One-stop-shops have also been created for more specific purposes in Greece and Ireland. Belgium and Luxembourg are among the Member States that are currently considering establishing one-stop shops, although with a slightly different scope.

ICT will undoubtedly play a key role in reducing administrative burdens and costs in the future. Establishing single-entry portals will provide easy access to information on government regulation, and can be used for reporting and the submission of returns from enterprises and citizens to public authorities. For example, VAT administration in Greece is now performed electronically. In many Member States such as Portugal, Spain and the UK households can submit income tax declarations using the Internet. The same option is available for VAT declarations of enterprises in Portugal. In Italy, for all the main tax obligations every taxpayer has the possibility to use only one tax form and make only one payment through banks, post offices or tax advisers. These intermediaries can in turn communicate with the tax administration through internet. Moreover, large companies can deal with the tax administration directly through internet. The

Netherlands have issued guidelines for reducing administrative costs of enterprises by making all forms available on the Internet, increasing electronic administration of businesses and making data collection from enterprises more efficient.

Box 3.3. Good Practice: Reducing the administrative burden.

One-stop shops – To facilitate easy access to public authorities, several Member States have recently set up one-stop shops which significantly reduce the administrative burdens associated with starting a new business and faced by SMEs and in some instances citizens in general. One-stop shops thereby facilitate the establishment and development of enterprises.

In Portugal two "Citizen Shops" opened in 1999, and six more are expected to open in the near future. They give citizens and enterprises easier access to public authorities by locating the main public services and utilities (a total of 33 entities) in the same place, and in the future the authorities plan to have a single point of entry through the telephone or Internet. Moreover, increased co-operation among public entities is expected, which should help reduce the administrative burdens and red tape for citizens and enterprises.

In Italy one-stop shops for production activities are opening. These are aimed at simplifying procedures and providing information, advisory and corporate support for new companies. By October 1999, a survey showed that one-stop-shops were in full working order or in an experimental phase in 25 per cent of the municipalities surveyed, while another 25 per cent were in the processing of setting them up. Most of the remaining municipalities were studying the issue.

In Spain, four "Single Business Window" shops were opened in 1999. For 2000 the objective is to create ten more and the idea is that all Town Houses will have one by 2001. The purpose is not only to facilitate the constitution of new companies, but also to give advice and information. For example, in the Valladolid case, 130 new firms were created between May and December 1999 and the delay for obtaining juridical personality has been reduced from 81 to 25 days.

Other Member States have similar centres such as France's "Guichet Unique", and also the UK is establishing a Small Business Service (SBS) to deliver a single gateway for support services for SMEs.

Use of ICT- With the diffusion of the Internet, ICT will in the future provide an excellent possibility to facilitate a less burdensome relationship between public authorities and citizen as well as enterprises. Italy implemented a comprehensive internet service for tax filing and remote access for tax returns. Last figures show that 88 per cent of all tax forms are dealt with through internet. Among other Member States, Belgium, Denmark and the Netherlands are currently in the process of establishing single entry Internet portals for enterprises giving easy access to official forms etc.

Promoting start-ups and SMEs

Besides efforts to secure access to capital, which are described below, *direct economic support or financing on favourable terms* for SMEs have recently been introduced in a number of Member States such as France, Germany and the UK to promote new businesses.

Portugal and the UK have in 1999 reduced *corporate taxation* of, respectively, micro enterprises and SMEs. Greece has reduced corporate tax on general partnerships, and the taxation of the self-employed now takes into account the size as well as the age of the company. France will eliminate the annual flat-tax for companies with a turnover of less than FF 500,000 in 2000. Austria has exempted business creators from a set of fees, and taxes have been reduced on business transfers. The simplification of the German tax system, which will take effect at the beginning of 2001, should reduce both the tax and administrative burdens on SMEs.

Another type of measure aims more directly at enhancing the management skills in smaller businesses and the establishment of a culture of entrepreneurship. Germany has initiated several schemes to *train founders of new businesses*, and Belgium and the UK are planning several measures to improve the training of management skills and the advisory services for SMEs.

3.2. Capital Markets

Although European capital markets have become gradually more integrated in recent years, a process strengthened by the euro, there is still much left to be done. The Commission's Financial Services Action Plan is providing new impetus to this process, as will recent measures taken by the Member States.

Many Member States are *changing the regulatory framework* for the financial sector, partly in response to changes in markets that have already occurred. New financial instruments and the creation of financial groups operating in all fields of the financial markets have necessitated some adaptation to the regulatory framework. In the UK, a new independent Financial Services Authority has been established. This authority replaced several regulators that previously dealt with specific areas of the financial sector. Portugal has taken steps in the same direction, and other Member States such as Ireland are considering similar moves.

A number of Member States have recently experienced the *creation and growth of financial groups*, dealing with a range of financial services such as various forms of insurance in addition to more traditional banking. To ensure a consistent regulation of financial groups with different structures and to avoid problems of the entire group, changes may be needed in prudential regulation and supervision as well as measures to ensure the transparency of financial markets vis-à-vis consumers. Finland and Sweden made legislative changes for that purpose in 1999, and in Denmark and Finland new legislation is expected in 2000.

Most Member States have seen *equity markets booming* in recent years. In Italy and Spain, the listing of privatised public enterprises played a key role, but the number of new listings by private companies also increased notably. Another important trend is the increased co-operation among the stock exchanges of the Member States. For example, co-operation agreements were made between the German stock exchange and the exchanges of Finland and Austria in 1998 and 1999, respectively. The stock exchanges of the Benelux countries as well as those of Sweden and Denmark have also entered co-operation agreements. Similarly, the derivatives exchanges of France, Italy, Portugal and Spain formed an alliance as did those of Finland and Germany. Further reorganisation and rationalisation can be expected in the coming years.

Capital taxation has also been adjusted in a number of Member States to improve the functioning of capital markets. For example, Finland and Italy have changed their tax systems in 1999 to ensure equal treatment of different financial instruments. In order to bring about more neutrality in the taxation of savings, the Netherlands plans to introduce a fixed capital tax rate of 30 per cent on a fixed imputed rent of 4 per cent of net property.

Corporate governance issues are being addressed in a number of Member States. The focus is on increasing transparency by making management more responsive to shareholders, clarifying the rules for change of ownership and improving the quality of information about a company and its prospects. Greece and Portugal issued general guidelines of *good corporate governance* in 1999, while best practices examples were published by the Finnish stock exchange. Austria introduced new legislation to ensure equal treatment for all shareholders during take-overs. The Netherlands plans to introduce legislation limiting the protective measures a company can have against take-overs.

Some Member States are seeking to strengthen the *development of life insurance and private pension funds*. Luxembourg introduced new legislation in 1999 which allows the establishment of various types of pension funds, while Germany is reflecting ways to encourage individuals to make own efforts to supplement their retirement benefits. The Commission has suggested in its Communication on supplementary pension schemes a comprehensive strategy to develop a single market for pension schemes. The harmonisation of prudential rules, the removal of obstacles to labour mobility and the further co-ordination of Member States' tax systems have been identified as key issues.

To *make existing pension funds more attractive*, a number of Member States introduced measures in 1999 to allow more flexibility in their portfolios. Belgium abolished a rule that made it compulsory for pension funds to invest at least 15 per cent of their portfolio in public securities. In Finland, pension funds can now invest a larger proportion of their portfolio in equity, and a distinction is no longer made between equity in Finland and the EEA. Finland along with other Member States is also encouraging pension funds to invest more actively in the venture capital market.

In recent years, there has been a strong focus on the *access to capital for SMEs and, especially, high-tech companies*. The promotion of venture and risk capital has been high on the agenda, and the Commission's Action Plan for Risk Capital is important for these efforts. To meet the growing demand for capital, many Member States have established new equity markets for high-growth and high-tech companies in recent years. In Germany this market has grown considerably during its three years of existence. Similar markets were established within the last two years in Denmark, Italy and Spain. Since the Italian new market started in June 1999, six firms have been listed. New markets are scheduled to come on-stream during 2000 in Greece and the UK.

To *strengthen the supply of private venture capital*, several Member States are reforming legislation governing undertakings for collective investment in transferable securities (UCITS). France has allowed the creation of UCITS which can invest up to 50 per cent in unlisted securities, although their distribution will be limited to qualified investors, and in Spain UCITS were allowed to invest up to 10 per cent in unlisted assets.

Many Member States also provide more *direct support to encourage venture capital investments*. Public investment funds have been created in countries like Belgium, Denmark, France and the Netherlands to provide capital for small high-tech enterprises. The UK is introducing several funds to provide access to finance for smaller innovative businesses. One fund will support equity investment in very early-stage, high-tech businesses, while another will specialise in providing small-scale equity to businesses with growth potential on a regional basis. In addition, Capital Gains Tax taper relief is available in the UK, with the aim of increasing incentives for entrepreneurial investment. Other Member States are also using tax breaks to promote private capital investment in this segment of the market. Direct public intervention can be justified if either the government possesses better information or has lower search costs than private investors. Yet it is important that such schemes are reviewed regularly to ensure that their benefits are appropriately balanced with the associated social costs.

However, lack of funds may not be the key barrier to the development of European venture capital markets. *Lack of competencies* to ensure successful venture capital companies and lack of information to allow for an efficient matching of potential investors and good ideas may be even more important. Public funds may therefore be better spent in developing these areas.

3.3. Policies for promoting R&D

On aggregate, Europe lags behind the USA and Japan in terms of the performance of high-tech sectors and innovative capacity. Improving the performance of the EU will be crucial in the transition to the knowledge-based economy. Ensuring a higher level of R&D, particularly in the private sector, could help to reduce the European deficit compared to the other main economic regions. An annex to this report outlines some general considerations concerning the role of R&D in the process of economic growth. Moreover, issues relating to the involvement of the public sector in R&D are discussed. The focus here is on the actual policies pursued by the Member States to promote R&D.

All Member States are pursuing policies to promote and increase R&D, in addition to those aimed at risk capital markets as mentioned above. However, the focus appears to be somewhat different, partly reflecting the wide dispersion of the current level of R&D in the Member States. Portugal having a low level of R&D expenditure is emphasising human capital formation. Other countries like the Netherlands and Spain are aiming to increase private sector R&D through tax reliefs. Similarly, Austria introduced tax breaks for R&D expenditure in 1999 and the UK will in 2000 introduce an R&D tax credit of 150 per cent, targeted towards SMEs. Yet all Member States have recently or are about to introduce measures to strengthen the links between public and private research activities.

As regards the *supply of R&D*, a number of Member States are taking initiatives to strengthen public research. Greece, Italy and Portugal are more generally increasing funding for public research institutions to compensate for very low levels of R&D expenditure, public as well as private. Ireland is taking a more selective approach by increasing funding for the development of key technologies under its National development Plan 2000-2006. Austria and Belgium are focusing more on creating centres of excellence, acknowledging that a critical mass of human and other resources is necessary to stimulate research at the frontier.

All Member States have for many years made efforts to ensure an efficient transfer of knowledge and technology from the public to the private sector. These efforts have been stepped up. Thus, almost all Member States are creating new institutions, programmes or schemes to *strengthen co-operation* between universities and other public research institutions, on the one hand, and individual or clusters of private enterprises on the other. One of the more ambitious and comprehensive programmes is the BioRegio of Germany, *cf. box 3.4*.

In addition to the creation of institutions such as science parks aimed at bridging the public and private sectors, a number of *specific measures* can be mentioned. Denmark is introducing a mobility programme, whereby public researchers can be employed directly by private companies for shorter time periods. The Netherlands are making it possible for high-tech start-ups to use the research and testing facilities of public research institutions. Moreover, Sweden has initiated programmes to support the transfer of knowledge from large enterprises to SMEs.

Box 3.4. Good Practice: Promoting public-private co-operation in R&D.

BioRegio initiative – The German Federal Government's "BioRegio" initiative consists of a variety of measures aimed at promoting the exploitation of biotechnology and of strengthening the link between biotechnology research and commercial implementation.

In 1996, the German regions competed for special awards by submitting integrated concepts for research in biotechnology including business applications. 17 regions took part in the competition, and three of them received special awards and are eligible for being granted a total of DM 150 million out of the national biotechnology programme for a period of five years, i.e. until 2002.

The competition induced a comprehensive effort by the regions to bundle their potential and formulate industrial strategies. Solid structures have been developed which provide specific support for technology transfer. Since then there has been a wave of business start-ups, which apparently also includes those regions not winning the initial competition. In 1997 there were 173 so-called core biotech companies in Germany, in 1998 the number has already risen to 222. According to a study carried out by the German authorities, Germany now ranks first in the number of patents per employee in biotechnology.

In 1998, BioRegio was supplemented by BioFuture, which is a competition addressed particularly to up-and-coming scientists. The aim is to encourage the rising generation and to form new centres of excellence for basic innovation in biotechnology. More recently a sponsorship programme, BioChance, was launched to support the research activities of young biotechnology companies.

Other Member States have also initiated programs, which aim at improving the co-operation between scientific institutions and industry. The "K-Plus" programme of the Austrian Federal government foresees the establishment of collaborative competence centres specialised in biotechnology, material science or IT. The "Brussels-Capital Region" in Belgium aims at improving the interface between schools for higher education, universities and the economic world in the areas of health, food-processing, communication and precision industry. A French FRF 100 million programme will facilitate the creation of networks of technological research involving enterprises, research centres and universities.

Apart from focusing on the transfer of public research to the private sector, there is some attention on *commercialising public research* more directly. France is reducing the restrictions on the external activities of public researchers, e.g. by allowing them to engage in business, and the Netherlands is increasing the autonomy of public researchers and research institutions. In Denmark, Finland, the Netherlands and the UK the patenting of inventions made in public research institutions is being promoted. Revenues from licensing may give institutions as well as individual researchers an incentive to focus more on research that can be applied by the private sector. However, a balance needs to be found. These schemes may divert resources into areas of research that might in any case be performed by the private sector, and away from research for the common good, which must be the primary purpose of public research.

Starting in 2000, the UK introduces an R&D tax credit of 150 per cent for SMEs, which also applies to new enterprises without any taxable profits. Austria and Greece have also recently introduced measures that provide direct support, either as cash grants or tax credits, for private sector R&D, and Spain intends to introduce similar measures in 2000. Italy is planning to provide fiscal incentives for private enterprises to hire researchers and encourage the use of qualified staff in business. Stimulating the demand for R&D through direct support can be justified, yet concerns regarding these measures were raised. *Direct support for private R&D* can involve a significant dead-weight loss, and may lead to a misallocation of resources, in particular scientists and engineers, who are in short supply.

In addition to the national policies for promoting R&D reviewed in this report, it is recognised that increased co-operation at the European level may play an important role in order to be able to exploit the economies of scale that undoubtedly exist in the production of knowledge.

3.4. Labour markets

Compared to the US and Japan, the EU has a substantial growth potential, which needs to be mobilised by structural reform. The EU employment rate is currently 63 per cent, whereas employment rates are above 70 per cent in both the USA and Japan. However, employment rates vary greatly within the EU. Thus, employment rates in Austria, Denmark, the Netherlands and Sweden are at the same level or slightly above those of the US and Japan. By contrast, Belgium, Greece, Italy and Spain have employment rates below 60 per cent, *cf. table 3.2*.

Table 3.2. Key labour market figures, 1999.

	Employment rate 1)	Unemployment rate 2)
	------------------- Per cent	---------------------
Austria	73.3	4.3
Belgium	57.2	9.0
Denmark	75.9	4.5
Finland	65.3	10.2
France	60.7	11.0
Germany	64.4	9.1
Greece	54.4	10.3
Ireland	62.7	6.6
Italy	57.3	11.3
Luxembourg	-	2.8
Netherlands	73.6	3.2
Portugal	70.2	4.7
Spain	56.9	15.9
Sweden	75.1	7.0
UK	69.6	6.1
EU	63.4	9.2
USA	73.2	4.2
Japan	75.9	4.9

1) Commission Services: Total employment in per cent of population 15-64.
2) Commission Services: Standardised rates in per cent of labour force.

Achieving higher employment requires a comprehensive combination of sound macroeconomic policies and structural reforms to raise labour force participation and reduce the level of unemployment compatible with low and stable inflation (structural unemployment).

Employment and participation rates are in most countries particularly low among elderly workers. Increasing employment for the elderly is in itself desirable, but it will also be an essential step in preparing for the ageing of populations.

Structural unemployment varies significantly among the EU countries and regions. Potential explanatory factors include different historical macro-developments, differences in the wage bargaining framework, the rigidity of various labour market regulations, tax-benefit systems, enforcement of benefit rules and the standard of education and training. An important factor generating structural unemployment is the mismatch between the demand and supply of labour, both in terms of skills and categories of labour, and among different regions.

Efforts in most countries concentrate on active labour market policies, improving education standards, reforms of tax-benefit systems, measures to increase flexibility and a better wage bargaining framework in order to combine high social protection levels with reductions in the non-inflationary level of unemployment.

Adopting a more preventive and active labour market strategy
Most EU countries have adopted more active labour market policies, in line with the employment guidelines. There has been a clear move towards a more preventive approach in combating long-term unemployment. But some Member States are more advanced than others and more needs to be done.

Active Labour Market Policy (ALMP) can, by improving skills and employability and by keeping people in touch with the labour market, contribute significantly to reducing structural unemployment. ALMP covers measures such as job offers, training, counselling and vocational guidance. A growing body of literature confirms the positive structural effects of ALMP, though much depends on the framework within which it is conducted. The most important factors include the quality of measures, early prevention, focus on rights, duties and enforcement, as well as focusing on targeted help to job re-entry instead of benefit-renewal.

As part of the Luxembourg process, the systems of ALMP and the interaction with benefit systems are continuously being developed and the effects are being more thoroughly assessed in a growing number of Member States. Further progress should therefore be expected over time, with effective targeting and a positive contribution from these policies in lowering structural unemployment.

An activation ratio[2] exceeding 20 per cent is set as a target for the Member States in the Employment Guidelines. Most countries fulfil or are close to fulfilling this target, although Austria, France, Greece and Portugal have not yet reached this goal, *cf. Joint Employment Report 2000*.

Austria, Sweden and the UK fulfil the target of offering all young and adult unemployed a new start before reaching respectively 6 and 12 months of unemployment (through training, work practice, a job or other employability measures). Denmark, Ireland and the Netherlands have made active programmes operational for all young unemployed before the 6 months threshold, but are still short of the common targets with respect to adult long-term unemployed. The Netherlands intends, however, to comply with this guideline by establishing a comprehensive approach before 2002.

The "New Deal" programme for 18-24 year old people in the UK starts when a young person reaches six months of unemployment, although some people with particular disadvantages in the labour market are eligible for early entry. New Deal begins with an intensive period of counselling, advice and guidance lasting up to four months. Those who do not find a job in that time and those who are not ready for a job are allowed to choose from a range of options including full time education or training (up to 12 months) or subsidised jobs (six months). Participants who refuse a suitable offer lose benefits. There are a number of other "New Deal"-programmes, e.g. for the disabled, lone parents, long term unemployed, partners of the unemployed, and people above 50.

The "New Services – Jobs for Young people" programme in France also contains elements of work-for-benefits. The programme is intended to create jobs in new business areas, especially in the service sector, where demand is not yet met by the market. A subsidy equivalent to 80 per cent of the minimum wage is paid for each job created by a non-profit organisation (e.g. an association, local authority, public establishment, etc.). The

[2] Defined as the annual average number of previously unemployed participants in active measures divided by the number of registered unemployed.

programme is targeted at young people between 18 and 25 years, or 26 to 29 if unemployed and not receiving unemployment benefit, but participation is voluntary. The subsidy is paid for a period of five years. By June 1999, 200,000 jobs had been created, and the final objective is to reach 350,000 jobs.

In Belgium, a "Convention for the First Employment" will come into effect this year. Aimed at those leaving the educational system, it will ensure a job activity for all within six months after leaving school. Firms that employ certain shares of school leavers will obtain some financial advantages.

As a component of a more preventive and active labour market strategy Sweden adopted a system with subsidised jobs for the long-term unemployed during 1999. The system improves employability of the long-term unemployed and reduces the risk of structural unemployment in Sweden. In Denmark, the active labour market policy requires that those reaching 12 months of unemployment are permanently in education or training.

Six Member States – Finland, France, Germany, Luxembourg, Portugal and Spain – have started the operational delivery of preventive policies, while Belgium, Greece and Italy have delays in implementation and policy specifications that fall short of the target.

Austria, Finland and the UK have recently put more focus on job-search assistance. Finland has taken action to strengthen job brokering by obliging job seekers to make more frequent contact with the Public Employment Service (PES). A number of Member States, in particular the Netherlands, have made progress in exposing their Employment Services to market forces. Greece and Italy have introduced legislation to allow the creation of private employment agencies, as well as decentralising the PES.

The Commission under the auspices of the Employment and Labour Market Committee has carried out a peer review including ten examples of Good Practices *cf. box 3.5*. In addition, the Joint Employment Report also describes seven examples of good practice from 1999.

Box 3.5. Good practice: Labour market policies.

1. Reduction of non-wage labour costs, particular for low-paid labour (Netherlands)
2. Women Entrepreneurship – Business Advisors for Women (Sweden)
3. Promoting Continuous training in Micro- and Small Enterprises (Portugal)
4. Activation and individual employment service (Finland)
5. "New Services – Jobs for Young People" programme (France)
6. Lifelong learning policies (UK)
7. Policies for the promotion of self employment (Germany and Italy)
8. Active policies against youth unemployment (Denmark and the UK)
9. Working time (France)
10. Social Partners Agreement on employment stability (Spain)

Source: *Joint Employment Report 1999* and peer review carried out by the Employment and Labour Market Committee.

Reforming tax-benefit systems

Several Member States have recently applied targeted reductions in social contributions in order to help low-skilled labour to maintain or enter employment. For instance, Belgium introduced during 1999 new measures to reduce social security contributions. In 2000, the total reduction will amount to 1.3 per cent of GDP and will be concentrated in particular at low incomes. In addition, expenditures on more targeted measures, for example to assist the first employment of youth, will be expanded.

In Spain, reductions in social security contributions for firms creating permanent jobs were extended into 2000 with a new programme. This is targeted at young people, women, the long-term unemployed and the over-45s. Italy introduced reductions in social security contributions in 1998 and 1999 with the aim of promoting the hiring of workers and creating new jobs. A three-year (1999-2001) reduction in social security contributions for newly hired persons in southern regions has also been introduced. Social security contributions for net new hires have been reduced in Greece.

In France as well, indirect labour costs are being reduced through lower social security contributions to boost labour demand. This has led to a substantial reduction in the labour costs of low-paid labour of almost 13 per cent, *cf. box 3.6*. By improving the demand for low-skilled labour with less than average labour market prospects, this contributes to reducing structural unemployment.

Box 3.6. Good practice: Cutting employers' social security contributions.

Several Member States have in recent years reduced social security contributions, often changing relative labour costs in favour of the low skilled.

France, for instance, has since 1993 progressively cut employers' contributions at the lower end of the wage scale. The intention was to boost the demand for low-skilled labour, which is expected to be more sensitive to labour costs than skilled labour, whilst maintaining the purchasing power at the lower end of the wage scale. By encouraging employers to substitute low-skilled for higher-skilled workers this may alleviate mismatches in the labour market, implying lower structural unemployment.

The reduction (called the "Ristourne dégressive") amounts to 12.6 per cent of labour costs at the minimum wage level and is phased out progressively as it rises to 1.3 times the minimum wage. As a result labour costs now better reflect productivity differentials. The effect of the reduction has now reached its full impact and some estimates suggest that it has created 250,000 additional jobs.

It should also be noted that in the context of the 35-hour working week further reductions in social security contributions have been implemented in the range between the minimum wage and 1.8 times the minimum wage.

Many Member States have implemented tax reforms in recent years, frequently with the specific purpose of lowering taxes on low-income workers, who often face high effective marginal tax and replacement rates. Most tax reforms involve tax shifting, e.g. by reducing the tax burden on labour income and raising energy and environmental taxes. However, progress has been slow in reducing the direct tax burden on labour income, which is still at the same high level as in 1994. Only a few countries have set national targets of reducing the overall tax burden.

Several Member States have reduced the tax burden and marginal tax rates on labour income in favour of low-paid and unskilled workers. Finland reduced income taxes in 1997 and 1999, and the government is committed to make further cuts during the coming years. Portugal introduced a lower income tax bracket and shifted some income allowances to tax credits favouring low incomes. The UK introduced cuts in income tax and national insurance contributions in 1999 and plans further reductions which will be implemented in 2000. Denmark and Italy will also continue to reduce taxes on low incomes.

Tax reforms aiming at more general reductions in income taxation have recently been implemented or are being reviewed in countries such as Austria, Belgium, Germany, Greece, Ireland, Luxembourg, the Netherlands, Spain and Sweden.

A reform of income taxation in three steps (1999/2000/2002) has been decided upon in Germany. In the framework of this reform the basic tax rate will be reduced by 6 percentage points to 19.9 per cent, the top rate will be reduced by 4.5 percentage points to 48.5 per cent and the tax-free basic income will be raised to over 14,000 DM. The 2002 stage of the reform will be brought forward to 2001. Further tax cuts will be introduced in two steps in 2003 and 2005 with a reduction in the basic rate to 15 per cent and in the top rate to 45 per cent. The basic allowance will be raised in two steps to 15,000 DM in 2005.

Ireland, Italy and the UK have introduced employment-conditional schemes. In the UK the Working Family Tax Credit (WFTC) replaced the previous Family Credit in October 1999. WFTC is in-work support paid via the tax system. The WFTC will increase the incomes of 1.4 million working families by an average £24 per week at a total cost of £5 billion per year (i.e. around 0,66% of GDP). As a result of WFTC and other tax reforms, the number of families facing effective tax rates of over 70 per cent will fall by two thirds.

The Netherlands plans to introduce a (non-targeted) tax rebate for all workers as an additional incentive for the unemployed to seek work. At the same time, marginal tax rates in the two highest income brackets will be reduced by 8 percentage points to, respectively, 42 and 52 per cent.

Box 3.7. Reforming tax-benefit systems to making work pay.

Low-skilled and inexperienced workers often face difficult employment conditions. In some countries, relatively high wage floors make it difficult for such workers to get a foothold in the job market, resulting in high and persistent unemployment. Conversely, where low-skilled workers can price themselves into the labour market, market earnings may not be sufficient to lift them and their families out of poverty.

Faced with the problems of unemployment or low pay amongst the low skilled, many countries have introduced schemes to increase their employment prospects and rewards from work. These schemes include direct wage subsidies, employment-conditional benefits or tax credits as well as reductions in labour costs via lower payroll taxes. The choice between these approaches is largely related to institutional and social considerations as well as to the characteristics of other welfare and labour market policy schemes in the country.

The different policies designed to make work pay address different problems in the labour market. A: Reducing social security contributions focuses in particular on increasing labour demand, as these reductions mostly reduce total labour costs within labour markets with relative rigid wages. B: In-work benefits, such as employment conditional tax-credits, reduce the effective after-tax replacement rate of unemployment- and other benefits, encouraging seeking and take-up of jobs (labour supply). C: The lowering of marginal tax-rates encourages labour supply in general, including the number of hours worked, and reduces a variety of other tax-related distortions, but are less targeted at after-tax replacement rates. As targeted in-work benefits raise effective marginal tax rates in their phase-out range a trade-off exists between these policies and reforms that reduce marginal tax rates.

Employment-conditional tax credits can be means tested with fewer distortions in countries with wide wage distributions, because fewer people are hidden by the increases in effective marginal tax rates in the phase-out range. Therefore employment-conditional schemes will give the best result in countries with a wide earnings-distribution and initially low marginal tax rates. Conversely they will create problems in countries with already high marginal tax rates and a narrow earning-distribution.

Several Member States have reviewed the duration and administration of unemployment benefit schemes. The maximum duration of benefits has been lowered in Denmark, Germany and the UK. Finland has reduced the replacement rate, as has Denmark earlier for the young unemployed. Austria, Denmark, Finland, Germany, the Netherlands and Sweden have also tightened eligibility or availability rules, which has improved incentives to search for jobs. Nevertheless, overall reform efforts in benefit systems have been relatively scarce. Moreover, further efforts seem to be necessary to avoid that people who are able to work switch to other benefit schemes such as invalidity and early retirement.

Wage formation

There has been some development towards more decentralised wage formation. In a number of Member States, a framework has been established within the last couple of years, which allows further decentralisation of wage bargaining, but it is still premature to assess the effects in terms of wage formation and employment.

In Spain, the 1997 agreement with the social partners foresaw opting-out clauses from centralised wage settlements. Even though some initial decentralisation has been made, further decentralisation may be called for to address significant regional disparities. A new "Social Pact for Development and Employment" was signed in December 1998 between the Italian government and 32 interested organisations. It provides a framework for territorial and area contracts, which allow for deviations from national standards of wage setting.

The "minimum wage-bargaining" system has also gained greater importance in the private sector over the past decade in a number of countries. Under this system central bargaining only determines increases in minimum wages, leaving other wage increases to be negotiated at the firm level.

Belgium has centralised wage bargaining by having a law on competitiveness setting an upper limit on aggregate wage increases. Whereas this law may induce proportional wage developments across sectors and skills, the last general agreement foresees various ways by which sectors that increase employment and training can differentiate wages more. In Germany talks over the "Alliance for Jobs" are ongoing. A framework agreement has been concluded which suggests, inter alia, moderate wage increases.

Flexibility of working hours and job security

Governments and the social partners continue to make efforts to improve both flexibility and security. In a number of Member States – Germany, Greece and Italy – greater flexibility is being introduced. In Italy, the pact of December 1998 between the Government and the Social Partners gives continuity to previous agreements, with the overall objective of making the Italian labour market more flexible.

Promotion of part-time work has been the subject of agreement between Social Partners and Governments in many Member States. This is the case in Spain where an agreement on promoting stable part-time employment was signed in November 1998. In Italy, a 1999 ministerial decree provides for reductions in social security contributions on part-time jobs.

Many countries have eased *regulation of fixed term contracts* in recent years. The maximum number of successive renewals has been extended in Belgium, Germany, Italy, the Netherlands and Sweden.

Although some countries have taken steps to achieve a better balance between flexibility and security, more progress could be made to modify employment protection legislation in many Member States in order to reduce disincentives for job creation. Limited progress was also reported in relation to the annualisation of working time or other types of schemes aimed at increasing flexibility.

3.5. Long-term sustainability of public finances

With few exceptions, the EU countries face substantial challenges due to demographic change in the not too distant future. Overall the effects of the ageing population are smaller in Europe compared to Japan, but larger when compared to the USA. Yet significant variations exist within the EU. The shift towards a relative larger share of elderly people in the population will be most pronounced in Ireland, Italy and Spain. In the case of Ireland, however, the increase comes from a low initial level. By contrast, Belgium, Denmark, Luxembourg, Sweden and the UK have relatively more favourable demographic forecasts, *cf. Annex II.*

Ageing raises the question of the long-term sustainability of public finances. It is primarily a problem for public finances due to increased expenditure on public pensions and public health care and services. The size of the challenge depends on the present level and future developments in demographics as well as the generosity of public pensions and health care systems.

Member States have different points of departure with respect to public finance positions, tax levels and the potential for higher employment, *cf. table 3.3.*

Table 3.3. Public finances and labour market indicators.

	Government surplus 1)		Debt 1)	Tax revenue 2)	Labour force 3)	Unemployment 4)
	1993	1999	1999	1996	1999	1999
	Per cent of GDP				Per cent	
Austria	-4.2	-2.0	64.9	43.0	71.6	4.3
Belgium	-7.2	-0.9	114.4	45.1	63.0	9.0
Denmark	-2.8	2.0	52.6	51.0	80.0	4.5
Finland	-7.3	2.3	47.1	48.2	74.4	10.2
France	-6.0	-1.8	58.6	45.6	66.2	11.0
Germany	-3.2	-1.2	61.6	38.1	69.9	9.1
Greece	-13.6	-1.6	104.4	39.2	61.7	10.3
Ireland	-2.7	1.0	52.4	33.5	66.6	6.6
Italy	-9.4	-1.9	114.9	42.5	59.1	11.3
Luxembourg	1.6	2.2	7.1	44.7	65.4	2.8
Netherlands	-3.1	0.5	63.8	43.2	75.3	3.2
Portugal	-6.0	-1.0	56.8	34.0	70.4	4.7
Spain	-6.7	-1.1	63.5	33.4	61.0	15.9
Sweden	-11.8	1.7	65.6	51.9	78.6	7.0
United Kingdom	-8.0	1.2	45.0	35.9	74.6	6.1

1) Commission Services. Surplus and debt levels in 1999 from Member States' EDP notifications (except Luxembourg where data was unavailable at the time of writing and Commission data is used).
2) OECD: *Surveillance of tax policies: A framework for EDRC country reviews*, 1999.
3) Commission Services. Civilian labour force in per cent of population 15-65.
4) Commission Services. Standardised unemployment rates in per cent of labour force.

Solid public finances and debt positions improve the chance that the forthcoming increases in expenditure for pensions, health and long-term care can be met without raising taxes or reducing benefits. Moreover, the scope for raising taxes to finance higher expenditure is limited in many Member States, most notably Denmark, Finland and Sweden, where the initial levels of taxes are already high.

Higher participation rates and lower structural unemployment levels will improve public finances. Initially high levels of unemployment and low participation rates provide an opportunity for further structural reforms to improve public finance positions and thus the ability to finance the challenge of ageing populations. The potential for improving participation rates and lowering structural unemployment is highest in Greece, Italy and Spain. By contrast, already high levels of employment limit the future potential for growth in countries like Denmark, the Netherlands, Sweden and the UK, and they will have to concentrate especially on measures promoting increased participation of persons at the fringe of the labour market.

Fiscal consolidation, debt reduction and pre-funding

Today the EU countries are in a better position to meet the challenge of ageing than they were just a few years ago, *cf. table 3.3*. Fiscal consolidation has increased the ability to meet the financial consequences of ageing populations. Further consolidation is expected in the years to come, motivated in part by ageing as mentioned in the stability or convergence programmes of many Member States.

Several Member States have a stated strategy of pre-funding future increases in expenditure. This funding can be either implicit or explicit. The implicit funding strategy is debt reduction. Reduced expenditure on interest payments can be used to finance the rising age-related expenditure. This is the strategy adopted by Belgium, Denmark, and Netherlands.

Spain, Sweden and, in particular, Ireland have chosen to explicitly pre-fund future pension liabilities. In these three countries, pension funds have been set up in order to prepare now for the public finance implications of an ageing population. In Ireland, from 1999, 1 per cent of GNP is being put aside annually as one step towards addressing the heavy long-term costs associated with demographic change, and substantial privatisation receipts have been assigned for the same purpose.

Explicit pre-funding highlights the major costs which ageing will pose in the future, and thus helps to focus timely attention on this issue. However, debt reduction may be more attractive and intuitive in Member States with large debt burdens, and where an already large number of explicit public and private pension funds may also pose challenges with respect to transparency.

Pension reforms and later retirement

As the proportion of the retired population expands, most Member States have started looking for ways to reduce the pressure of state pensions on public finances. Many have focused on the length of time spent in retirement, while others have adjusted pension benefits and contributions. In a few Member States comprehensive pension reforms have addressed both issues, *cf. box 3.8*.

Later retirement both broadens the tax base and reduces public expenditure on early retirement and pension schemes. Promoting the participation of older workers is therefore important, especially in Member States with initially high employment rates and low unemployment. Austria, Belgium, Denmark, Germany and the Netherlands have introduced measures mainly focused on encouraging later retirement – either by reforming early retirement schemes or by making public pensions more actuarially fair. In some cases the reforms are probably inadequate to stop the apparent secular trend towards earlier retirement.

Box 3.8.Good practice: Pension reforms.

Pension reforms are high on the agenda in most Member States, and several have recently introduced measures aimed primarily at increasing the average retirement age.

Belgium is currently reforming its pension system to ensure that the retirement age of men and women is aligned at 65, by progressively increasing the normal retirement age for women from 60 to 65. This will be done over a 12-year transitional period from 1997 to 2009. Over the same period the calculation underlying female pensions will change from a 40-year to a 45-year base, for a full career and maximum entitlements. Moreover, while Belgian workers will still be able to apply for early retirement, they will have to ensure that, by 2005, they have worked for a minimum of 35 years. Greece and the UK are also moving to a uniform retirement rate at age 65 for men and women.

Spain is increasing the minimum contribution period to ensure that contributions and benefits are more closely linked; and France requires workers to have made pension contributions for 160 quarters (or 40 years) before they can draw a full state pension. Moreover, France, which has the lowest participation rate of people below the official retirement age (i.e. among the 55-65 age group), is making efforts to encourage those 55-65 year olds who are unemployed and inactive back into the labour force instead of taking early retirement.

Other member states, such as Austria, are establishing incentive structures to *encourage* later retirement with higher payments if people opt to continue in the labour force beyond the official retirement age. This system will also *discourage* early retirement, by reducing pension payments if workers retire before the official retirement age.

Sweden has made a more comprehensive pension reform improving the long-term sustainability of public finances and reducing the pressure on future generations. The size of pensions is for example calculated as an annuity at the time of retirement. If average life expectancy increases, the annual payment becomes lower. The phenomenon of double ageing – reduced labour force and increased longevity – is thereby reduced by removing the part of the problem due to increased longevity. A "break mechanism", which will adjust the wage indexation of pension rights in the face of unfavourable economic or demographic developments, guarantees a fixed contribution rate of 18.5 per cent.

More comprehensive pension reforms have been implemented in Finland, Italy, Spain and Sweden in the 1990s. These reforms are aimed at encouraging later retirement as well as reducing more directly future public pension expenditures. The latter objective has been achieved either through lower pension benefits and higher contributions or as in Sweden by introducing a mechanism that will break the automatic link between increased life expectancy and public pension expenditure.

By indexing public pensions to an index lower than the increase in wages, pension expenditures – as a percentage of GDP – will decline over time. At the moment Belgium, Finland, Germany (temporarily) and Greece use such an index system. Italy, Spain and the UK are indexing pensions purely to a price index. The political sustainability of a pension system with price indexing over a prolonged period of time will depend in part on the overall increase in income of the old age population, compared to other groups. The propagation of private pensions and savings is important in this respect.

In countries where pensions are wage-indexed the need to reverse the trend towards earlier retirement and general measures to increase labour supply and employment are particularly important. The fiscal pressure from rising pension expenditures will not be significantly alleviated by economy-wide productivity increases as the resulting gains in living standards and tax bases will be shared with transfer recipients. Productivity increases in services for health and care for the elderly, however, may alleviate pressures.

Private sector pension schemes

In most countries labour market pension funds or individual private pensions are being built up. This development is important with respect to life-cycle preferences and the development of capital markets. The potential benefit to public finances, however, relies entirely on the extent to which these schemes are substitutes or supplements to public schemes and the extent to which the schemes enjoy preferential tax treatment.

Need for further reforms

Despite the reforms that have already taken place in many Member States, further measures are required in most countries. It is clear that many elements of pension reforms work best when they are mutually reinforcing and consistent with national circumstances. Given the complexity of the issues, there is no single answer or specific reform that will solve all the demographic problems at once.

Yet many Member States need to formulate a complete and coherent strategy. These strategies should set out the principles for dealing with the economic consequences of an ageing population. The aim should be to secure sustainable public finances, continued economic progress and social cohesion in the European Union.

4. Implementation of the Broad Economic Policy Guidelines

The Broad Economic Policy Guidelines (BEPGs) form the centre of the economic policy co-ordination process at the Community level. The BEPGs draw together and direct the different processes which include the Cardiff multilateral review of economic reforms, the Luxembourg co-ordinated European employment strategy and the Cologne macro-economic dialogue by putting forward an integrated view. The Ecofin Council has stated that it will pay increased attention to the implementation of the BEPGs and asked the EPC to carry out a rigorous peer review.

The 1999 BEPGs consist of two sets of recommendations. The first are general recommendations addressed to economic actors in all Member States. Three main areas of structural policy were covered under the general recommendations: more efficient product (goods and services) markets; more integrated and deeper capital markets; and better functioning labour markets.

The second are country-specific recommendations. These highlight the areas which the Council considered to be the most important for action in each Member State. Implementation of these country-specific recommendations in the areas of product, capital and labour markets is examined below.

Taking all fifteen Member States as a whole, most of the country-specific recommendations have been at least partially implemented. Nevertheless, the degree of implementation varies between policy areas and Member States.

Progress has been strongest in areas such as: implementation of Single Market legislation; liberalising the telecommunications and electricity markets; facilitating part-time work; and implementing a preventative approach to tackling youth and long-term unemployment.

Progress has been weaker in areas such as: implementing and enforcing public procurement rules; liberalising the transport, water, gas and postal sectors; deregulating retail outlets; developing risk capital markets; reforming benefit systems; and reviewing employment protection legislation.

Box 4.1. 1999 country specific recommendations on product, capital and labour markets.

Austria: (1) accelerate transposition of Single Market Directives in transport and public procurement (2) reform the 1988 cartel law and create an independent Cartel Office (3) reform public services and accelerate process of deregulating utilities (4) consider further steps to liberalise shop-opening hours (5) simplify business start-up procedures (6) take measures to develop a venture capital market (7) make progress to meeting objective of raising R&D expenditure (8) to retain older workers in activity improve work incentives, modernise the organisation of work and review early retirement conditions (9) place special emphasis on low skilled and low wage workers. There was one recommendation on the 1999 NAP which was adopted after the NAP had been presented by the Austrian authorities. The final recommendation on working time flexibility required no action by the Austrian authorities.

Belgium: (1) improve record on implementing Single Market directives, especially for telecommunications and transport (2) further liberalise the network industries (3) do more to activate unemployed adults (4) review benefit duration and the availability of the unemployed (5) consider making employment protection legislation less strict, and (6) facilitate the use of opening clauses to allow wage negotiations to better reflect local labour market conditions.

Denmark: (1) strengthen and apply more vigorously existing competition regulations (2) encourage the use of competitive tendering into the provision of public services (3) implement electricity sector reforms without delay (4) further review liberalisation of shop-opening hours (5) fully implement and closely monitor recent reforms to benefit schemes (such as early retirement) (6) evaluate the latest tax reform, and consider further reducing the high tax wedge on labour, and (7) reconsider leave schemes in the light of the need to increase the labour supply.

Finland: (1) give the national authorities powers to enforce articles 81 and 82 of the EC treaty (2) increase competition in service sectors where public enterprises play a large role (3) reduce the overall tax burden on labour (4) increase job availability, make job search more effective and increase the incentives to take up job offers in the benefit system, and (5) review early retirement conditions.

France: (1) improve implementation of Single Market legislation, particularly for telecommunications (2) reduce non-agricultural state aid (3) make faster progress in liberalising the network industries, particularly the energy sector (4) continue efforts to simplify formalities and encourage innovation (5) review unemployment benefit schemes and employment protection legislation (6) continue recent policy of tax cuts at the lower end of the wage scale and the promotion of jobs in certain service areas, and (7) in implementing the 35-hour week, special attention should be paid to avoiding an increase in the cost of labour and to the introduction of more flexibility regarding work organisation and working time.

Germany: (1) improve the implementation of Single Market legislation relating to public procurement (2) reduce state aids (3) liberalise services, including retail distribution (4) accelerate business registration procedures for creating SMEs (5) review benefit schemes and, (6) continue to shift the tax burden away from labour and assess the impact of employment protection legislation on SMEs.

Greece: (1) improve implementation of Single Market legislation, especially for public procurement (2) privatise state-owned enterprises (3) help the creation of new firms by reducing the administrative burden, further developing venture capital markets and expanding the stock market (4) stimulate business R&D expenditure (5) reinforce preventative approach of labour market policies and reform the education and training system, and (6) encourage flexible working hours and part-time contracts.

Ireland: (1) improve transposition of Single Market legislation, especially for transport (2) give the Competition Authority powers to enforce Articles 81 and 82 of the EC Treaty (3) consider initiatives to promote competition in telecommunication, electricity and gas supply, and domestic and international transport (4) continue measures to encourage venture capital and improve R&D performance (5) place greater emphasis on preventative as well as active policies for the unemployed, and increase the participation of certain groups in education and training (6) adhere to the social pact as a means of furthering wage moderation and, (7) avoid the potential negative effects from setting the minimum wage level too high.

…………continued on the next page

Box 4.1. Continued.

Italy: (1) improve implementation of Single Market legislation, especially for transport and public procurement (2) reduce state aids and improve its structure (3) intensify transport liberalisation (4) reduce the number of procedures and time for registering a company (5) increase the coverage of active labour market measures (6) continue efforts to shift the tax burden away from labour (7) reform benefit schemes to reduce the numbers being transferred to pensions and other schemes (8) encourage early activation and adequate unemployment benefits to ensure an increased labour supply and greater labour mobility (9) review employment protection legislation, and (10) encourage tripartite local agreements in the South which introduce wage flexibility in line with labour productivity.

Luxembourg: (1) speed up implementation of Single Market regulations, especially in telecommunications and transport (2) reduce regional state aids (3) consider abolition of the price regulation system and shift to a more active competition policy and, (4) implement measures to raise the low employment rate of women and older workers.

Netherlands: (1) speed up transposition of Single Market directives, particularly in transport (2) assess reforms to competition policy and implement fully the measures included in the "Competition, Deregulation and Legislative Quality Project" (3) speed up liberalisation of the public transport sector (4) review spatial planning regulations (5) continue efforts to reduce the overall tax burden on labour, especially for low-wage earners and, (6) make further efforts to ensure that there are sufficient incentives in benefit and assistance schemes to encourage the take-up of job offers.

Portugal: (1) accelerate transposition of Single Market regulations, especially in public procurement, telecommunications and transport (2) reduce state aids (3) bring anti-trust regulation into line with EU legislation (4) further liberalise the network industries (5) adjust the licensing law relating to large retail outlets (6) reduce administrative requirements for creating new businesses (7) develop a venture capital market (8) reform the benefit system to ensure appropriate incentives to take up job offers and to participate in active measures (9) pursue policies to enhance labour market flexibility.

Spain: (1) further improve transposition of Single Market legislation, particularly for transport (2) reduce sector-specific state aids (3) deregulate retail distribution (4) reduce the number of procedures and time taken for company registration (5) implement law to promote industrial innovation (6) reinforce competition policy (7) shift from passive to active labour market policies with particular emphasis on training and education (8) continue efforts to reduce the tax wedge on labour and discourage early retirement (9) reinforce recent agreements to reduce the cost of dismissal, and (10) social partners should adapt wages developments to reflect productivity differentials.

Sweden: (1) give the competition authorities powers to enforce Articles 81 and 82 of the EC treaty (2) improve the efficiency of the public sector (3) take further measures to increase competition and to promote new entry into the utilities sectors (4) reconsider regulations limiting the establishment of grocery stores (5) reduce the overall number of participants in labour market programmes and increase the proportion involved in labour market training (6) further reduce taxes on labour, in particular at the lower end of the wage distribution (7) further review benefit and assistance schemes.

United Kingdom: (1) make further efforts to transpose Single Market regulations, particularly in transport (2) strictly enforce new competition legislation (3) stimulate the growth of SMEs, innovation and R&D (4) continue efforts to lower marginal effective tax rates on low-paid workers (5) make further efforts to deal with regional unemployment differences and address the issue of social inclusion.

Overall *Austria* showed progress in implementing its country-specific recommendations. Changes have been made to the tax code to encourage businesses to invest in R&D and non-repayable grants are being given to "centres of competence" which facilitate the transfer of knowledge between business and academia. Low-wage and low-skilled workers will benefit from the tax reform and from increased on-the-job training and early activation. However there has not been much progress with regards to further liberalising shop-opening hours even though the new government has defined longer shop-opening hours as a priority. Moreover, although the July 1999 Cartel Act brought Austrian competition policy more into line with Community rules, it contained no provision for the Cartel Office to be made more independent.

Overall *Belgium* showed some progress in implementing its country-specific recommendations but more needs to be done. For example, the non-transposition rate declined from 5.2 per cent in Nov 1998 to 3.5 per cent a year later. The unemployed aged 25-45 are increasingly being offered individual action plans and have access to subsidised jobs after two years of unemployment. However, liberalisation of the network industries is in general only keeping pace with the requirements of Community legislation and price levels in many of these industries remain high. Moreover, there has been no consideration of employment protection legislation for white-collar workers.

Overall *Denmark* showed good progress in implementing its country-specific recommendations. For example, the current tax reform (Whitsun package) aims to reduce marginal tax rates, for the low-paid in particular, although the overall tax burden on labour income remains high. The early retirement scheme has been reformed to make it financially more attractive to continue in employment and the early withdrawal scheme for the long-term unemployed is being phased out. However, in public service tendering the areas where calls for tender are compulsory remain very limited. In addition, the Competition Council still lacks powers to enforce Articles 81 and 82 of the EC Treaty.

Overall *Finland* showed good progress in implementing its country-specific recommendations. For example, income tax cuts have reduced the overall tax burden on labour and more are planned. Some market-oriented procedures are being tested in the municipalities, hospitals and education. However there have been no concrete measures to give the national authorities powers to enforce Articles 81 and 82 of the EC Treaty even though the government has the intention of reviewing its national competition legislation as the corresponding projects (Commission white paper on modernising competition policy) proceed at Community level. As regards the long-term sustainability of the pension system, even though promising measures agreed with the social partners to extend the effective retirement age have been put into force, these measure will probably not be sufficient to cause the 2-3 years increase in the average age of leaving the labour market which the government is aiming at.

Overall *France* showed some progress in implementing its country-specific recommendations but more needs to be done. For example, measures have been taken to facilitate the creation of new companies such as simplifying tax formalities, reducing administrative charges and promoting the provision of risk capital. A number of measures have also been taken to reduce non-wage labour costs on low wages. However France's non-transposition rate for Single Market legislation rose slightly from 5.5 per cent in Nov. 1998 to 5.6 per cent in Nov. 1999 although the government has declared that accelerating the transposition of directives is a priority. Employment protection legislation has been made slightly more strict by the Delalande-contribution, which aims at temporarily improving the situation of older workers.

Overall *Germany* showed progress in implementing its country-specific recommendations. State aids were reduced steeply over the last 3 years particularly ad hoc aid to manufacturing, although due to the ecological tax reform the amount of tax relief increased. Regulations which affected the exercise of some professional services were liberalised. However, several public procurement directives are only just about to be transposed and the value of tenders published in the Official Journal needs to be increased. Moreover, further progress could be made to liberalise shop opening hours in retail distribution.

Overall *Greece* showed progress in implementing its country-specific recommendations. For example, the privatisation process has begun in the telecommunications, transport, energy and banking sectors but the authorities are maintaining a majority stake in most of these firms. A new stock market has been established for small and medium-sized innovative firms. However, the non-transposition rate of Single Market legislation rose from 5.2 per cent in November 1998 to 6.2 per cent in November 1999 and needs to be improved. Moreover, there continue to be problems in getting firms to introduce more part-time contracts and flexible working hours as provided for in the 1998 labour market reforms.

Overall *Ireland* showed progress in implementing its country-specific recommendations. Measures have been put in place to encourage venture capital funding such as the Access to Finance scheme. The authorities also plan a substantial increase in the budgetary resources allocated to R&D for the period 2000-06. However, there have been few measures to further liberalise the railways and urban bus transport sectors. Moreover, although competition policy is under review, the Competition Authority still does not have the power to enforce directly Articles 81 and 82 of the EC treaty.

Overall *Italy* showed some progress in implementing its country-specific recommendations but more needs to be done. The non-transposition rate for Single Market legislation declined from 5.7 per cent in Nov. 1998 to 3.9 per cent in Nov. 1999, although several indicators point to problems in applying Single Market rules. The authorities have also taken steps to liberalise transport, such as separating the management of the railway infrastructure from the operation of services and converting local bus services into commercial companies. However, the administrative burden for registering new companies remains high, although the increasing number of "one-stop shops" should help in this context. In addition, no significant progress has been made in reviewing employment protection legislation.

Overall *Luxembourg* showed progress in implementing its country-specific recommendations. For example, parental leave was introduced and childcare facilities were increased in 1999 to try to raise female labour participation. However, the price regulation system has not yet been abolished even though the government intends to do so.

Overall *the Netherlands* showed very good progress in implementing its country-specific recommendations. Competition policy has been made more effective by extending the powers of the Competition Authority into the network industries and introducing better co-ordination with the sector-specific regulators. A series of measures are planned in 2000 and 2001 to further reduce administrative costs and to simplify business licensing requirements for firms. Public transport is being liberalised by granting concessions for part of the regional rail transport network and by privatising parts of urban and regional transport. However, the number of non-transposed directives in the area of transport remains relatively high. Further effort is required to ensure there are appropriate incentives in taxation, benefit and assistance schemes to take up work. Special efforts are required to reduce the number of people registered as disabled.

Overall *Portugal* showed some progress in implementing its country-specific recommendations but more needs to be done. For example, the authorities took measures to reduce the time for corporate registration down to as low as 14 days. In addition state aids as a percentage of GDP show a continuing decline. However, the law restricting the licensing of large retail outlets remains in force, even though the law is being amended in the course of the current year. Moreover, there have been no recent reforms to the benefit system to ensure appropriate incentives to take up job offers and participate in active measures.

Overall *Spain* showed progress in implementing its country-specific recommendations. The non-transposition rate of Single Market legislation declined from 2.7 per cent in Nov. 1998 to 2.2 per cent in Nov. 1999 and the number of non-transposed transport directives came down from seven to four over the same period. In addition, new legislation has been introduced to improve competition and industrial innovation policy. However, there has been no further reinforcement of measures to reduce the cost of dismissing employees and little progress has been made in making wages better reflect productivity differentials between regions, sectors and enterprises.

Overall *Sweden* showed progress in implementing its country-specific recommendations. For example, the share of the labour force participating in labour market measures was reduced from 4 per cent in 1998 to 3 per cent in 1999, and labour market training was given more priority. Several measures were also taken to increase competition within the public sector which have created scope for privately-managed services, for example in the provision of nursing homes and sheltered accommodation. However, the regulations which inhibit the establishment of grocery stores have not been revised. Nor has any action been taken to review benefit systems, although a government bill addressing this issue is planned for later this year.

Overall the *United Kingdom* showed good progress in implementing its country-specific recommendations. For example, the growth of small businesses was promoted by a reduction in corporation tax for SMEs, and an Enterprise Fund is being created to provide risk capital and guarantees to SMEs. The authorities have lowered marginal tax rates by introducing a 10 per cent starting rate of income tax and a Working Families Tax Credit which is designed to reduce the number of families facing very high marginal effective tax rates. However, the overall non-transposition rate of Single Market legislation rose from 2.1 per cent in Nov. 1998 to 2.8 per cent in Nov. 1999 although it remains below the EU average. A new Competition Act came into force on 1 March 2000, so as yet no assessment of the enforcement of this legislation can be made.

Annex I
Policies to promote R&D

Accumulation of knowledge is continuously becoming more important as driver of economic growth and increased standards of living. Yet our understanding of the determinants of knowledge accumulation and the complicated processes by which knowledge is diffused, turned into innovation and enhances economic growth is incomplete. Another reservation is that the statistical data in this area is more uncertain than normal. Thus, the available indicators of the generation of knowledge and of inputs into knowledge production such as R&D expenditures are imperfect.

Knowledge is fundamentally a public good. This means that everybody can access and apply knowledge without limiting the ability of others to apply the same knowledge. With the progress made in information technologies and the expansion of the Internet, knowledge can now be accessed world wide easier and faster than ever.

Knowledge is to a large extent generated by the R&D activities of the private and public sectors. Expenditure on R&D in the European Union are only two-thirds of the expenditure in the USA and Japan, when measured relative to GDP. The European Union also has a deficit in terms of R&D indicators such as the number of scientists, patents and innovations. Efforts must be made to correct this deficit.

Table 1. R&D expenditure and patent applications.

	R&D expenditure			Resident patent applications per 10,000 inhabitants, 1996
	Year	Per cent of GDP	Private share of R&D	
Austria	1998	1.6	≈ 50	2.33
Belgium	1998	1.6	≈ 65	0.88
Denmark	1998	2.0	60	2.53
Finland	1998	2.9	61	4.32
France	1997	2.2	60	2.25
Germany	1998	2.3	≈ 65	5.25
Greece	1997	0.5	23	0.39
Ireland	1997	1.5	74	2.22
Italy	1998	1.1	≈ 55	1.24
Luxembourg	-	-	-	2.14
Netherlands	1996	2.1	54	1.59
Portugal	1998	0.7	< 33	0.09
Spain	1998	0.9	≈ 50	0.59
Sweden	1997	3.9	75	4.72
United Kingdom	1997	1.9	65	3.10
EU	1998	1.8[1)]	55[2)]	2.62
USA	1998	2.8[1)]	65[2)]	4.03
Japan	1998	2.9[1)]	70[2)]	26.94

1) Commission estimate.
2) 1995.
Source: European Commission, *Policies for Promoting Research and Development*, 2000, and OECD, *Main Science and Technology Indicators*.

Two other observations are important, however. First, *R&D expenditure varies greatly among the Member States.* Countries like Sweden and Finland spend relatively more on R&D than both the USA and Japan, and they may be a useful benchmark for other Member States. Second, *public expenditure on R&D is almost the same in Europe, the USA and Japan*, implying that the European deficit is primarily to be found in the private sector.

Based on the second observation, the backlog of R&D in the European Union should not primarily be solved by increases in public research, although this would indeed be appropriate in a few Member States. Governments should focus on measures that facilitate and support private R&D and increase the market orientation of public R&D. Creating the framework conditions for private investments in R&D is vital. These include the funding of basic research, the creation of centres of excellence, and the dissemination of information in particular between public and private research centres.

Ensuring a sufficient supply of human capital, in particular within sciences and engineering, is a crucial precondition for the success of policies to promote R&D. In a broader context, the availability of appropriate and abundant human skills is also necessary if increases in knowledge are going to be exploited efficiently in the production of goods and services.

As the stock of knowledge increases, research will tend to be more specialised as each researcher can only master a relatively small area. There is therefore a risk of public research becoming too fragmented. Efforts must be made so that public research is cohesive in order to achieve the desired level of excellence. *Promoting research networks* at the national, European and global level is one possibility. Another is to establish *research centres in specific areas and of a size that exceeds the critical mass* for undertaking research at the frontier.

To strengthen the focus on areas of commercial value, initiatives aimed at *enforcing the intellectual property rights* of public research results, for instance through patents, may be considered. Yet care should be taken in *striking the right balance*. Giving public researchers a share of proceeds from licensing will undoubtedly increase the awareness of the commercial use of public research. But it may also divert public resources into research that should properly be undertaken by private enterprises, and away from basic research of a more general public value, which ought to be the primary target.

The public sector also has a role to play in *encouraging entrepreneurship and start-ups of new R&D intensive businesses*. Including entrepreneurship and business economics in the curriculum of institutions of higher learning to encourage graduating students to set up their own business may have positive effects. In particular, it may be possible to achieve a direct spin-off in the form of new enterprises based on the work of research students. In a similar vein, public research institutions can aid start-ups by giving them access to research and testing facilities on favourable terms.

Diffusion of knowledge accumulated within public research institutions must also be given a high priority. Otherwise it cannot be used by industry to the benefit of consumers at large. There is a range of means to achieve this. *Formal and informal co-operation between public and private researchers* based on comparative advantages; the establishment of science parks conducive to co-operation among public and clusters of private enterprises; leave-schemes enabling public researchers to be employed in private enterprises for shorter periods of time are just a few examples.

Developments in product and capital markets also have an important influence on private sector R&D. The benefits of R&D come only over a longer time period, while the costs are paid up-front. Therefore, the *availability of capital is crucial for all R&D activities*. This may be a significant barrier for SMEs, in particular new business, as they may have more difficulties to finance their activities through own savings. Establishing the right conditions for venture or risk capital markets is therefore important. Venture capital is particularly important, because it also provides new firms with important managerial skills.

Competitive product markets are important, because they provide incentives for enterprises to strive for product and process innovation. In addition, free access to global markets enables enterprises to reap the full benefits of having made a new innovative product. Thus, making entry into business simple and reducing barriers to international trade will increase the incentives of private enterprises to engage in R&D activities. These incentives can be further enhanced if intellectual property rights are secured. The public sector can contribute by making the enforcement of legislation covering intellectual property rights effective.

All of the above measures are aimed at either increasing the supply of R&D resources available to private enterprises or establishing well-functioning markets for knowledge including an efficient diffusion and transfer of knowledge obtained through public R&D activities. In other words, *they emphasise the need for strengthening the framework conditions for private sector R&D.*

There may be a case for supplementing these measures by more direct support for R&D activities in the private sector, in particular for SMEs. If private enterprises are not able to appropriate all the benefits from their R&D efforts, they will devote too few resources to R&D. Thus, the social benefits of R&D can be larger than the private benefits. This externality could in principle justify direct public support for R&D, thereby reducing the costs to private enterprises.

However, the size of the spillover from the R&D of one enterprise to other enterprises will vary greatly. One R&D project may be of no use to other enterprises, while another can be exploited by many enterprises. Identifying *a priori* projects with large spillover effects is not an easy task. Consequently, governments will often have to rely on general schemes for direct support to private R&D. Since general schemes will also provide support for R&D projects that would be undertaken anyway, they will involve a substantial dead-weight loss. This problem may be enlarged as companies will have an incentive to reclassify activities as R&D. If the insufficient level of R&D is predominantly due to constraints on the supply side, promoting private R&D can cause a misallocation of scarce resources. For example, scientists and engineers may be moved into R&D activities, even if the return to their work might be higher in other parts of the productive process.

While direct support for private R&D may be clearly justified on theoretical grounds, the way in which support schemes are implemented in practice must be carefully considered to avoid creating new distortions that could be larger than the initial market failure.

Annex II
Policies to secure long-term sustainability of public finances

This Annex provides a short overview of the medium-term demographic projections for the European Union and the challenges that ageing populations are posing on Member States' public finances. Moreover, it presents a summary description of the general characteristics of pension systems in the European Union. Some policies recently implemented to face the problem of rising pension expenditures are also recalled. Finally, it illustrates the work programme of the Working Group on the Implications of Ageing Populations recently established by the EPC with the objective to analyse more deeply the public finance and economic effects of ageing populations for the European Union.

Demographic and public finance projections

Because of declining fertility rates and rising life expectancy, the share of the elderly in the EU population has progressively increased since the middle of the 1980's. Over the period 1985–2000, the old age dependency ratio (defined as the ratio of the population over 65 to the population between 15 and 64) has risen from 0.20 to 0.24 in the EU as a whole. So far, the rising share of the elderly has been partially offset by the decreasing share of the young. The total dependency ratio (defined as the ratio of the population below 14 and over 65 to the population between 15 and 64) has therefore been around 0.49 since the second half of the 1980's. However, even this indicator shows a marginal increasing trend since the beginning of the 1990's and should reach 0.50 in the current year.

As shown by Eurostat's baseline projections, both old age and total dependency ratios are likely to accelerate their rise in the first half of the current century especially as a result of the ageing of the so-called "baby boom generation". Over the period 2000-2050, the old age dependency ratio is expected to increase of the order of 0.23 points in the EU as a whole (from 0.24 to 0.47). In five countries (Belgium, Denmark, Luxembourg, Sweden and the UK), the increase is expected to be below 0.2; in seven countries (Austria, Finland, France, Germany, Greece, Netherlands and Portugal) to be between 0.2 and 0.25; and in three countries (Ireland, Italy and Spain) to be above 0.25. Such increases in old age dependency ratios should be mirrored by similar increases in total dependency ratios.

Demographic developments in countries of the European Union are putting pressure on their public finances. In 1997, resources absorbed by social protection expenditures for old age were equal to 12.2 per cent of GDP on average in the European Union[3]. In particular, current pension systems are deemed to require a substantial increase of resources because of demographic causes. According to current estimates, most pension systems will experience the most significant pressures during the period between 2010 and 2030. Also health care and other care sectors will be significantly affected by ageing.

Table 1. Dependency ratios in the European Union, per cent.

	1980	1990	2000	2010	2020	2030	2040	2050
Total............................	55	49	50	52	55	63	71	72
Old age	22	22	24	27	32	39	47	47

Source: Eurostat's baseline projection scenario.

[3] Source: Eurostat, SESPROS databank, social protection expenditure for old age and survivors.

Pension systems in Europe

European pensions systems include the following three pillars:

1. Publicly operated regimes with mandatory contributions or general tax-financed. They cover old age pensions. They usually secure benefits of both former workers and non-workers. They are run as pay-as-you-go systems, and are generally subsidised by the central government. In most European countries these regimes cover around 80 per cent of the population.
2. Complementary Mandatory regimes (labour market pension schemes). They are earnings-related and usually funded or partly funded.
3. Individual complementary regimes adhered to on a voluntary basis, mostly managed by private pension funds. They receive a favourable tax treatment and are based on a capitalisation and/or actuarial system. Similar to insurance policies, they are still infrequent in continental Europe but are expanding rapidly.

The vast majority of European pensions system puts the greatest weight on the first pillar. Mandatory regimes cover the working population and guarantee a minimum old age pension in the case of invalidity, disability and various form of early retirement. Public pension systems aim at reaching the goal of full coverage of the population and point now towards streamlining benefits and reducing the growth of expenditures. They require contributions from the working population, are generally unfunded or partially funded and operate on a pay-as-you-go principle. Most countries do not distinguish between Pension Funds and general Social Security Funds. The unfunded systems are financed with central government funds. In some cases, earmarked taxes are levied but in most cases general revenues cover the Social Security deficits.

Pension funds assets, operating in the two complementary regimes, amount to less than 10 per cent of GDP in most European countries[4], although deemed to increase rapidly. In some countries these funds cover much larger assets.

The fiscal problem of ageing relates to the first pillar of pension systems, which include the obligations of government to provide pension benefits. The second and third pillars are important in their own respect, but the public finance effect of these mainly or totally private sector schemes depends entirely on the extent these schemes supplement or substitute public expenditures. Substitution effects depend on the degree of means testing of public pensions and/or discretionary reductions of growth in public pensions. Preferential tax treatment of private sector schemes also affects the net public finance effects of the schemes.

Retirement age varies among different countries, generally between male and female workers and sometimes also between public and private sector employees. However, recent reforms are aimed at reducing gender differences and differences between categories of job, and there seems to be a common trend toward establishing the legal retirement age at around 65 years of age. Contribution years vary as well among countries ranging between 15 and 40. Minimum contribution periods (usually 5 years) are required to receive an old-age pension. In all countries discrepancies between the legal and observed retirement age are observed. The *de facto* retirement age is much lower than the legal one in most countries, ranging from 55 to 62 years of age. Measures are being considered to favour an actuarially

[4] Pension funds assets, whether private funds or company pension funds are relatively well developed in Denmark, Finland, Ireland, the Netherlands, Sweden and the UK, according to 1996 OECD data.

neutral way to keep people in the labour force and in some cases to favour part-time work after retirement. Economic incentives to postpone retirement are being implemented in most countries.

Calculation of pensions takes various forms and is different from country to country: from a flat rate pension to a percentage (from 60 per cent to 100 per cent) of average pensionable income, calculated as an average of previous earnings. Difference exists also in reference earning-years used for calculating average pensionable income, although there is a general tendency to lengthen the calculation periods. Calculation methods are being modified in some countries, so that future benefits are gradually going to be calculated with a contribution based method. Pensions are usually taxed as income, with exemptions for lower brackets.

In several countries indexation of pensions is recently being detached from wage performance, and linked to price performance, with some room for discretion.

All countries are using or are about to implement models to monitor the impact of ageing on their Social Security systems. To face the problems arising from expected increases of pension expenditures and more generally old-age related expenditures some countries are pre-funding part of their prospective costs (financing it with different means: general or specific taxation, interest savings from public debt reductions, proceeds from privatisation). Many countries have introduced or will introduce significant reforms aimed at reducing public financing of the systems. Most reforms launched in the 1990's aim at:

1. Tighten eligibility schemes (reducing exemptions, increasing retirement age, requiring longer contribution periods, diminishing benefits).
2. Expand the contributory base, by keeping the active population in the labour force, reducing unemployment and increasing female participation to the labour force.
3. Increase the role of "occupational" pension, earnings-related, funded and linked to the development of Pension Funds.

Mandate of EPC Working Group on the Implications of Ageing Populations
In November 1999, the EPC established a Working Group on the Implications of Ageing Populations (WGA). The objective of the WGA is to provide a quantitative assessment of the public finance and economic consequences of ageing populations in the 15 Member States of the European Union. Initially, the work programme of the WGA is mainly of a positive type. Later, the analysis will also address policy issues. The work is initially concentrating on pensions. Later work may continue on implications for health care and care for the frail elderly.

In a first stage, the WGA will review the "state of the art" concerning expenditure projections already existing at national level. An interim synthesis report based on Member States' answers to a comprehensive questionnaire should be prepared in March 2000. In a second stage, the WGA will prepare a proposal on demographic and macroeconomic assumptions for each country, to be agreed by all Member States' experts. Subsequently, Member States' delegations will be asked to calculate projections using the common indicators and the agreed macroeconomic and demographic country-specific assumptions. Given the complex institutional details characterising most social security systems, Member States' experts should remain responsible for the methodology used to obtain the projections. At this stage, the WGA will work closely with the OECD working group dealing with very similar issues. Finally, the new projections provided by the Member States could be used as inputs to macroeconomic models. Moreover, at this stage the analysis could become more policy-oriented. For example, the public finance and the macroeconomic models could be used to simulate the effects of a reform from current (mainly) pay-as-you-go systems to mixed systems or, as a point of reference, to fully funded systems.

Annex III

List of good practice examples provided by Member States

Austria	1. Taking areas out of the public sector: Schönbrunn Palace 2. Taking areas out of the public sector: State-owned forests
Belgium	1. R&D: Collaboration between universities and industry
Denmark	1. Surveillance of EU regulations for open procedures 2. Whitsun package: Tax reform for employment and savings
Finland	1. Frame budgeting procedure for the public sector 2. Use of market mechanisms for state-owned real estate 3. Pilot studies in service production exposed to competition 4. Children's day care 5. Curbing industrial subsidies
France	1. Increasing the employment content of growth 2. TRACE Programme: Employability of youngsters 3. Tax incentives to promote SME access to capital markets 4. Promoting R&D and entrepreneurship
Germany	1. BioRegio initiative: Promoting R&D in biotech sector 2. ProInno programme: SME competence for innovation 3. Initiatives for diffusing ICT 4. Modernising the vocational training system 5. Participation capital for small technology-oriented companies
Greece	1. Establishment of stock market for SMEs 2. Improvements in public sector administration 3. One-stop shop for larger investment projects 4. Public-private partnerships in infrastructure projects 5. Policies to promote corporate sector efficiency
Ireland	1. Public finance implications of demographic ageing 2. Action Programme on Regulatory Reform 3. Telecommunications liberalisation 4. Back to Work Allowance Scheme 5. Reform of tax and social welfare system
Italy	1. Privatisation as an instrument to develop equity markets 2. Electronic tax filing 3. One-stop shops
Luxembourg	1. Creation of one stop shops "formalities centers" 2. Comprehensive legislation for the promotion of electronic commerce
Netherlands	1. MDW: Competition, deregulation and quality of legislation 2. Separate handling of reductions in administrative burdens 3. Market and Government: Hive-off market-based activities

Portugal	1. The Citizen Shop 2. Internet at School Programme 3. NÓNIO 21st Century Programme: Competence centres 4. Towards a Digital Economy 5. Living Science Programme: Learning centres for all
Spain	1. Competition policy reform 2. One-stop shops 3. Pension Reserve Fund 4. Securitisation of SME loans
Sweden	1. Swedish electricity market deregulation 2. Swedish telecommunications market deregulation
United Kingdom	1. The UK approach to competition policy 2. The UK approach to utility regulation 3. Working Families Tax Credit (WFTC)