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COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE AND THE COMMITTEE OF THE REGIONS

Annual Growth Survey: advancing the EU's comprehensive response to the crisis

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The context

This first Annual Growth Survey marks the start of a new cycle of economic governance in the EU and the first European semester of economic policy coordination. The EU has taken decisive action to deal with the crisis: as a result, the deterioration of public finances and the increase in unemployment have been less marked than in other parts of the world. The EU's high levels of social protection cushioned the worst impact of the crisis but because of its weak productivity growth, recovery is slower in Europe.

According to the latest forecasts, there are signs of economic recovery albeit still uneven. While financial markets remain volatile, the real economy has shown signs of improvement in some quarters, led by growing exports after the resumption of global trade. Nonetheless uncertainties remain. Periods of renewed confidence in the return to growth alternate with setbacks, also due to the risks associated with the sovereign debt market. European economies face major adjustments. The financial sector has not yet returned to normal conditions and there are situations of vulnerability to stress and dependency on state-support. Credit conditions are not yet back to normal and in a number of Member States household and corporate debts are still excessive.

Impact of the crisis

In spite of the prompt response given by the EU, the legacy of the crisis is far reaching. It has resulted in a large loss in economic activity, a substantial increase in unemployment, a steep fall in productivity, and badly weakened public finances. By the end of 2012, eleven Member States are expected still to remain at output levels below those preceding the crisis. In 2010, EU gross government debt rose, on aggregate, to around 85% of GDP in the euro area and to 80% EU-wide. The budgetary impact of the crisis will compound the effect of demographic change, which will add a fiscal burden of some 4.5% of GDP in the long term. Structural weaknesses that were not tackled before the crisis have become more apparent and urgent.

The crisis has taken a heavy toll on Europe's societies, despite the cushioning provided by welfare systems. The rise of unemployment is a central problem. On aggregate, 9.6% of the working population is unemployed. In some countries, youth unemployment can be as high as 40%. Around 80 million people are estimated to live below the poverty line in Europe.

The economic crisis was a global crisis, but its impact is very different across the world. While unemployment and public deficits increased more sharply in the US than in the EU, the crisis has aggravated the labour productivity gap between the EU and the US. Price and cost competitiveness remain problematic. Emerging economies are returning to growth at a faster pace although some of them also face major economic challenges. Therefore, the EU needs to use this crisis to address decisively the issue of its global competitiveness.

Outlook

The crisis could have a lasting effect on potential growth. Medium term potential growth for Europe is projected to remain low and estimated at around 1.5% up to 2020 if no structural action is taken namely to resolve the labour productivity gap with our main competitors. Given its cyclical nature, recovery alone cannot provide the impetus for leading Europe back to the pre-crisis economic situation and absorb the deficit accumulated.

To avoid stagnation, unsustainable debt trends, accumulated imbalances and ensure its competitiveness, Europe needs to accelerate the consolidation of its public finances, the reform of its financial sector and to frontload structural reforms now.

That is why the European Council adopted the Europe 2020 strategy with ambitious targets for a new growth path[1]. The preliminary indications of Member States on their national targets in the five areas agreed under the Europe 2020 strategy clearly show the road that the EU has to travel to deliver its own ambitions.

If fully implemented, this strategy will help the EU come out stronger from the crisis and turn the EU into a smart, sustainable and inclusive economy delivering high levels of employment, productivity, competitiveness and social cohesion. This will deliver the competitive social market economy of the twenty first century, boosting confidence of market actors, companies and citizens alike.

The Annual Growth Survey launches the European semester

In this context, the EU has also decided to change its economic governance. January 2011 launches the first European Semester of ex-ante policy co-ordination starting with this Annual Growth Survey which is anchored in the Europe 2020 strategy.

This Annual Growth Survey brings together the different actions which are essential to strengthen the recovery in the short-term, to keep pace with our main competitors and prepare the EU to move towards its Europe 2020 objectives.

Given the urgency, the Commission has chosen to present 10 priority actions. The Commission will continue its work on a broad range of other policy areas, including trade and a host of internal policies. These are not developed here. In this Communication the Commission focuses on an integrated approach to recovery concentrating on key measures in the context of Europe 2020 and encompassing three main areas:

– The need for rigorous fiscal consolidation for enhancing macroeconomic stability

– Labour market reforms for higher employment

– And growth enhancing measures

This first Annual Growth Survey is designed to apply to the EU as a whole but will need to be tailored to the specific situation of each Member State. The proposed course of action is particularly relevant for the euro area which is currently affected by the sovereign debt crisis.

[1] Raising the employment rate, raising the investment levels in R&D, meeting our climate change and energy objectives, improving tertiary or equivalent education levels and reducing early-school leaving, promoting social inclusion through the reduction of poverty.

Fiscal consolidation, structural reforms and growth enhancing measures are necessary ingredients for the comprehensive response the euro area must give to the crisis.

But such a comprehensive response will have to include other elements, e.g. the review of the European Financial Stability Facility (EFSF). As regards the latter the Commission considers that the effective financing capacity of the EFSF must be reinforced and the scope of its activity widened. This Annual Growth Survey also constitutes a contribution to the comprehensive response of the euro area to the sovereign debt crisis.

Moreover, progress in establishing a permanent mechanism for resolving sovereign crises is needed to provide certainty and stability in markets. The new European Stability Mechanism should complement in 2013 the new framework for reinforced economic governance, aiming at an effective and rigorous economic surveillance, including reviewing the effectiveness of current financial backstops.

A more detailed analysis underpinning the Commission's assessment is set out in 3 reports that accompany this Communication and include an assessment of the initial setting up of the Europe 2020 strategy at Member State level.

I. MACRO-ECONOMIC PRE-REQUISITES FOR GROWTH

1. Implementing a rigorous fiscal consolidation

The most urgent task for the EU is to restore confidence by preventing a vicious cycle of unsustainable debt, disruption of financial markets and low economic growth. Public expenditure must be put on a sustainable track as a pre-requisite for future growth. Annual adjustments of the structural budget balance in the order of 0.5% of GDP will be clearly insufficient to bring debt ratios close to the 60% requirement. Therefore, stronger consolidation is needed and should be implemented on the basis of the reinforced fiscal rules proposed by the Commission.

- All Member States, especially those in excessive deficit procedure, should keep public expenditure growth firmly below the rate of medium term trend GDP growth, while prioritising sustainable growth friendly expenditure in areas such as research and innovation, education and energy. All Member States should demonstrate that their Stability or Convergence Programmes are based on prudent growth and revenue forecasts.

- Member States in excessive deficit procedure should set out the expenditure path and the broad measures they intend to take in order to eliminate of their excessive deficits.

- Member States facing very large structural budget deficits, very high levels of public debt or high levels of financial distress need to frontload their efforts in 2011. Where economic growth or revenues turn out to be higher than expected, fiscal consolidation should be accelerated.

- Some Member States may need to increase taxes. Indirect taxes are more growth-friendly than direct taxes and broadening tax bases is preferable to increasing tax rates. Unjustified subsidies, e.g. environmentally harmful subsidies, should be eliminated.

2. Correcting macro economic imbalances

Large and persistent macroeconomic imbalances are a major source of vulnerability, especially within the euro area. Many Member States need to tackle their lack of competitiveness with greater urgency.

- Member States with large current account deficits and high levels of indebtedness should present concrete corrective measures (these could include strict and sustained wage moderation, including the revision of indexation clauses in bargaining systems).

- Member States with large current account surpluses should identify and tackle the sources of persistently weak domestic demand (including further liberalisation of the service sector and improving conditions for investment). However, where domestic demand still remains subdued due to a policy or market failure appropriate policies should be put in place.

3. Ensuring stability of the financial sector

At EU level, the regulatory framework must be further reinforced, while the quality of supervision should be enhanced by the ESRB and European Supervisory Authorities, which have become operational at the beginning of 2011. Bank restructuring must be accelerated to safeguard financial stability and underpin the provision of credit to the real economy.

- Restructuring of banks, and particularly those which received significant amounts of state aid is essential to restore their long-term viability and ensure a properly functioning credit channel. Public financial support for the banking sector as a whole should be gradually withdrawn, taking into account the need to safeguard financial stability.

- In accordance with the recently agreed Basel III framework, banks will be required to progressively strengthen their capital base so as to improve their capacity to withstand adverse shocks. The Commission is also working on a comprehensive bank crisis resolution framework. In addition, another more ambitious and stringent EU-wide stress test will be conducted in 2011.

II. MOBILISING LABOUR MARKETS, CREATING JOB OPPORTUNITIES

There is a risk of a return to growth without sufficiently dynamic job creation. Tackling unemployment and preventing long term exclusion from the labour market is essential. One of the five EU targets of the Europe 2020 strategy is to raise the employment rate to 75% by 2020. Current indications are that the EU will fall short of this target by 2-2.4% - a shortfall that can be made up through the adoption of measures to create jobs and increase labour participation. Given the ageing of the EU population and the relatively low utilisation of labour compared to other parts of the world reforms are needed to promote skills and to create incentives to work.

4. Making work more attractive

The combination of high unemployment rates, low participation in the labour market and fewer hours worked compared to other parts of the world undermines the EU's economic performance. The participation rate of low income earners, young people and second earners is worryingly low. The most vulnerable face the risk of long term exclusion from employment. In response, training and job search should be tied more closely to benefits.

- Shifting taxes away from labour should be a priority for all Member States in order to stimulate demand for labour and create growth.

- Tax benefit systems, flexible work arrangements and childcare facilities should be geared to facilitating the participation of second earners in the work force. Efforts need to be stepped up to reduce undeclared work both by strengthening the enforcement of existing rules and reviewing tax benefit systems.

5. Reforming pensions systems

Fiscal consolidation should be supported by reform of pension systems, making them more sustainable.

- Member States that have not already done so should increase the retirement age and link it with life expectancy.

- Member States should reduce early retirement schemes as a priority, and use targeted incentives to employ older workers and promote lifelong learning.

- Member States should support the development of complementary private savings to enhance retirement incomes.

- In view of demographic change, Member States should avoid adopting measures related to their pension systems which undermine the long term sustainability and adequacy of their public finances.

- The Commission will review the Directive on pension funds[2] and present new measures as follow up to the Green Paper on Pensions launched in 2010.

6. Getting the unemployed back to work

European welfare systems have worked to protect people during the crisis. However, once the recovery has gained ground, unemployment benefits should be reviewed to ensure that they provide incentives to work, avoid benefit dependency and support adaptability to the business cycle.

- Member States should design benefits to reward return to work or incentives to go into self-employment for the unemployed through time-limited support, and conditionality linking training and job search more closely to benefits.

- Member States need to ensure that work pays through greater coherence between the level of income taxes (especially for low incomes) and unemployment benefits.

- Member States need to adapt their unemployment insurance systems to the economic cycle, so that protection is reinforced in times of economic down-turn.

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[2] Directive 2003/41/EC of the European Parliament and of the Council of 3 June 2003 on the activities and supervision of institutions for occupational retirement provision (OJ L 235, 23.9.2003, p. 10).

7. Balancing security and flexibility

In some Member States employment protection legislation creates labour market rigidity, and prevents increased participation in the labour market. Such employment protection legislation should be reformed to reduce over-protection of workers with permanent contracts, and provide protection to those left outside or at the margins of the job market. At the same time, reducing early school leaving and improving educational achievements is essential to help young people to have access to the labour market.

- Member States could introduce more open-ended contracts[3] to replace existing temporary or precarious contracts in order to improve employment perspectives for new recruits.

- Member States should simplify their regimes for the recognition of professional qualifications to facilitate the free circulation of citizens, workers and researchers.

III. FRONTLOADING GROWTH –ENHANCING MEASURES

The EU will only meet its ambitious Europe 2020 targets for sustainable and inclusive growth if urgent structural reforms are frontloaded in services and product markets to improve the business environment. To remain competitive in a globalised economy Member States must urgently begin the deep structural reforms needed to enhance the excellence of our research and our capacity to innovate, turning ideas into products and services that meet the demand of high-growth markets, taking advantage of the technological capabilities of our industry and helping SMEs to grow and internationalise. The EU's reform agenda will also have to exploit new sources of growth by turning the limits of traditional resource-based development into new economic opportunities through increased resource efficiency. It must also exploit the EU's first mover advantage on competitive environmental goods and services.

The Single Market can be an important source of growth –as outlined already in the Communication on a Single Market Act- provided quick decisions are taken to remove remaining obstacles. To strengthen it, the Commission will therefore give priority in the Single Market Act to growth enhancing measures in 2011-2012 as illustrated below.

8. Tapping the potential of the Single Market

Barriers to market entry and obstacles to entrepreneurship remain acute in the single market. Cross-border services only represent 5% of GDP, less than a third of trade in goods and only 7% of consumers buy on-line because of the numerous restrictions which prevent the development of cross-border on-line sales.

- All Member States should fully implement the Services Directive. The Commission is evaluating its implementation, and the potential for further growth enhancing measures through a further opening of the service sector.

- Member States should identify and remove unjustified restrictions on professional services such as quotas and closed shops together with restrictions on the retail industry, such as disproportionate limitations on opening hours and zoning.

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[3] As proposed by the Commission in its "New skills and jobs Europe 2020 flagship" - COM(2010) 682 final/2, 26.11.2010.

- The Commission will propose in 2011 measures to rule out geographically based differentiation in e-commerce inside the Single Market. It will also propose a European framework for intellectual property, as this is a key factor for developing both e-commerce and digital industries.

- In addition to continuing to press for the conclusion of the Doha Round, the Commission will advance negotiations on Free trade agreements with partners such as India, Canada and Mercosur, and step up regulatory convergence work with major partners and increase symmetry in access to public procurement markets in developed countries and large emerging market economies.

- In 2011, legislation will be proposed to enable rapid and interoperable standard-setting including in ICT.

- Although sensitive, work should be taken forward on taxation. This has an important economic potential to stimulate growth and job creation, reduce administrative burden and remove obstacles in the Single Market. Tax treatment disadvantaging cross-border trade or investment should be eliminated. In particular the Commission will propose in 2011 measures to modernise the VAT system, to introduce a common consolidated corporate tax base, and to develop a coordinated European approach to taxation of the financial sector. Progress on taxation also implies reducing taxes on labour to the minimum necessary and adapting the European framework for energy taxation in line with the EU energy and climate objectives.

9. Attracting private capital to finance growth

Innovative solutions are required to mobilise urgently a greater share of private EU and foreign savings.

- The Commission will make proposals for EU project bonds to help bring public and private financing together for priority investments notably in energy, transport and ICT and will also include these innovative financing instruments in its forthcoming proposals for the next Multi annual Financial Framework.

- To facilitate access to finance for SMEs and innovative start-ups, the Commission will make proposals to enable venture capital funds established in one Member State to operate freely anywhere in the EU and to eliminate remaining tax obstacles to cross-border activities.

10. Creating cost-effective access to energy

Energy is a key variable for growth. For business, energy prices are a key cost element. For consumers, energy bills represent an important item of the household budget and a particular challenge for low income households. Current plans by Member States risk falling far short of the overall 20% energy efficiency target set in the Europe 2020 strategy. This would lead to lost opportunities for growth across many sectors and regions and loss of employment creating possibilities.

- Member States should rapidly implement the third internal market energy package in full.

- Member States need to step up their energy efficiency policies. This will lead to significant savings and create jobs in the construction and services sectors.
- In 2011, the Commission will propose initiatives to take forward the transport, energy or telecommunication infrastructure needed for a truly integrated single market.
- The Commission is developing EU-wide standards for energy efficient products to help the expansion of markets for innovative products and technologies.

Ensuring delivery

The most urgent task in 2011/2012 is to prevent a vicious cycle of unsustainable debt, financial market disruption and low economic growth. The first priority of this Annual Growth Survey is to set budgetary policies on a sound footing through rigorous fiscal consolidation, and to restore the normal functioning of the financial sector. The second priority is a rapid reduction in unemployment through labour market reforms. But tackling these two priorities will be ineffective without a major effort to frontload growth at the same time.

Such policies would also have a positive impact on budgetary consolidation, by generating higher tax revenues and lower public spending on social transfers, and will help reduce the risk of future macroeconomic imbalances. Structural reforms will generate gains already in the short term. Output as well as employment gains are driven by product market and labour market reforms.

Trade is a strong driver of growth. There is a huge untapped potential for export of EU goods and services, but Europe's exports were hit hard by the collapse in global trade. The positive export performance of some Member States shows that success in global markets rests not only on price competitiveness but also on wider factors such as sector specialisation, innovation, and skills levels that enhance real competitiveness.

In this first Annual Growth Survey the Commission has set out 10 actions for the EU in 2011/2012, anchored in the Europe 2020 strategy. It proposes that these form the basis of an agreement by the European Council that Member States should commit to the implementation of these 10 actions. Given the interdependencies of Member states, in particular in the Euro area, ex-ante coordination in the Council is the essential element of the European semester.

Based on the guidance of the European Council, Member States should present by mid-April their national commitments in their medium term budgetary strategies under the Stability or Convergence Programmes and set out in their National Reform Programmes the measures needed to reflect this comprehensive response to the crisis anchored in the Europe 2020 Strategy. Based on recommendations from the Commission, the Council will issue country-specific policy guidance before the summer that Member States should take into account when preparing their budgets for 2012 and in implementing their growth policies. In the spirit of the integrated approach to policy coordination, the Council will assess the fiscal and growth strategies together, looking at their ambition, consistency and their implications at the EU level including the interdependencies within the euro area.

The Commission proposes that upcoming meetings of the European Council should review regularly its implementation, to identify gaps at Member State and EU level and agree rapidly on corrective measures. The proposals set out in this Communication would already enable the next meeting of the European Council to take concrete steps to maintain and accelerate the momentum of efforts to frontload and raise growth, and agree on the timetable for implementing the comprehensive response to the crisis. For the latter, the European Council has already agreed on two benchmarks: for finalising work on the permanent European Stability Mechanism (ESM) by March and the legislative package to enhance economic governance in the EU by June. In the meantime, the publication of the results of a new stress-test will give guidance on the strategy to be followed in completing the repair of the banking sector.

This first Annual Growth Survey is also transmitted to the European Parliament and to the other Institutions and national parliaments.