Modtaget via elektronisk post. Der tages forbehold for evt. fejl

Europaudvalget
(Alm. del - bilag 922)
Det Europæiske Råd
(Offentligt)

PØU, Alm. del - bilag 71 (Løbenr. 13658)

Medlemmerne af Folketingets Europaudvalg

og deres stedfortrædere

Bilag	Journalnummer	Kontor	
1	400.C.2-0	EU-sekr.	16. marts 2001

Til underretning for Folketingets Europaudvalg vedlægges i forbindelse med Det Europæiske Råd i Stockholm den 23.-24. marts 2001 Kommissionens og Rådets rapport om offentlige finansers bidrag til vækst og beskæftigelse, 6997/01.

REPORT

from :	The Commission and the (ECOFIN) Council
to :	The European Council (Stockholm, 23/24 March 2001)
Subject :	The contribution of public finances to growth and employment: improving quality and sustainability

HIGHLIGHTS

The European Council in Lisbon has set a new strategic goal for the European Union "{{NEL}}to become the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion." Public budgets can contribute to achieving this goal by fostering growth and employment through three channels {{SPA}} supporting a stable macroeconomic framework via sound public finances, making tax and benefit employment friendly and redirecting public expenditures towards physical and human capital accumulation. Broadening the focus from achieving budgetary stability towards putting the emphasis on the overall contribution which public finances can make to growth and employment marks a new step in the fiscal policy agenda in EMU.

Sustaining sound public finances: after many years striving to achieve sound public finance positions, the challenge now is to complete this goal and sustain these positions while at the same time lowering the tax burden (especially on low-paid labour), strengthening public investment in physical, human and knowledge capital and preparing for the budgetary consequences of ageing populations. Therefore:

- to meet the short-run challenges, and consistently with the Stability and Growth Pact, the Council and the Commission affirm the need to avoid pro-cyclical fiscal policies, especially by strict expenditure control. The Council and the Commission agree that in this respect cyclically-adjusted balances be used as an additional tool when assessing budget positions. Further refinement of the method for determining the cyclical component of the budget balance will be pursued by the Commiss ion in co-operation with the EFC and the EPC

- to meet the medium-term challenges, tax and expenditure reforms must be designed to achieve a sustainable reduction in the tax burden and maximise their contribution to growth and employment. To this end, tax cuts need to be accompanied with a firm control on and, where appropriate, reduction of public expenditure. They should also target the removal of rigidities, especially in the labour market. An appropriate balance and sequencing has to be drawn between running down public debt, cutting taxes, and financing public investment in key areas. This balance can vary according to the particular circumstances and priorities of Member States.

- to meet the long-term challenges, the Council and Commission agree that a three-pronged strategy is needed to tackle the economic and budgetary challenges of ageing populations. This should include a suitable combination of running down public debt at a faster pace, measures to raise employment rates (especially amongst women and older workers), and reform of pension systems to place them on a sound financial footing including greater recourse to the funding of public pensions. The EC OFIN Council intends to deepen its examination of the long-term sustainability of public finances, in particular in the framework of the multilateral surveillance and the stability and convergence programmes.

Making tax and benefit systems more employment friendly: some progress has been made towards making tax systems more employment-friendly, by lowering the fiscal burden on labour as well as reducing marginal tax rates. However, overall labour taxation (taxes and social security contributions) in many Member States still remain high by international standards, and reforms in some countries have been piecemeal. Much less progress was made in making benefit systems more employment frie ndly, and changes in net replacement rates have been relatively small. Only few Member States have developed in-work benefits to boost earnings of low-paid workers. The Council urges Member States to accelerate where appropriate the reforms of tax and benefits systems with the objective of making work pay and curb unemployment traps.

Redirect public expenditures towards physical and human capital accumulation: recent trends show that levels of public investment have stopped declining and are starting to increase in some countries, a welcome development as it has been combined with efforts to increase efficiency via the introduction of market mechanisms. In restructuring public finances, priority should be given to education, training and R&D. Efforts to enhance physical and human capital accumulation must t o a large extent come through expenditure restructuring. The Council urges Member States to pursue a balanced combination of spending restructuring, tax reforms, and other structural measures. Only through such comprehensive strategy the EU can meet the Lisbon challenge.

1. Background and aim of the Commission-Council report

At the meeting in Lisbon on 23-24 March 2000, the European Council set a new strategic goal for the EU, namely "{{NEL}}*to become the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion."* This strategic goal recognises the need to build upon the considerable economic achievements of the 1990s, especially the establishment of a stabili ented policy framework that culminated with the launch of the euro. To meet the Lisbon challenge, the EU must be ambitious and transform itself into a Community of stability and dynamism.

All resources must be mobilised to achieve the Lisbon goal. With public expenditures and taxes accounting for between 40 to 50% of national income in EU Member States, public finances have a central role to play in realising this objective. To this end, the Lisbon European Council requested the Council and the Commission

to present a report to the Spring 2001 European Council assessing "*the contribution of public finances to growth and employment, and on the basis of comparable da ta and indicators, whether adequate concrete measures are being taken in order to:*

- *alleviate the tax pressure on labour and especially on the relatively unskilled and low-paid, improve the employment and training incentive effects of tax and benefit systems;*
- *redirect public expenditure towards increasing the relative importance of capital accumulation {{SPA}} both physical and human {{SPA}} and support research and development, innovation and information technologies;*
- *ensure the long-term sustainability of public finances, examining the different dimensions involved, including the impact of ageing populations, in the light of the report to be prepared by the High Level Working Party on Social Protection*

".

This joint Commission-Council report is the response to that mandate. It is based on a Commission Communication on the quality and sustainability of public finances adopted on 21 December 2000. The Commission Communication analyses the role of public finances in meeting the Lisbon objectives and contains a detailed assessment of progress being made by Member States in the above mentioned areas. This joint report focuses on the main policy conclusions, and outlines a strategy for maximisin g the contribution of public finances to growth and employment.

A major aim of the joint Commission-Council report is to ensure that all policy measures to achieve the Lisbon objectives are mutually reinforcing, with full account taken of their public finance implications. In the drive to reform tax and benefit systems, and to redirect public expenditures towards physical and human capital accumulation, it is imperative that the commitment to sound and sustainable public finances be credibly adhered to. This joint report marks a new step in the fiscal policy agenda in EMU, by broadening the focus from achieving budgetary stability towards putting the emphasis on the overall contribution which public finances can make to growth and employment.

2. How public finances affect growth and employment

There is broad agreement on three main channels through which public finances can enhance potential growth and employment

- *Sound public finances contribute to a stable macroeconomic climate*
  . Sound public finances are a necessary condition for sustained economic growth. Firstly, sound public finances contribute to macroeconomic stability and support monetary policy in maintaining stable prices at low interest rates. Both effects are conducive to private investment and saving. Secondly, sound public finances, by reducing public debt and consequently the interest burden, create room for a reduction in taxes and/or an increase in productive public spending. Finally, sound public finances also enhance growth and employment in the long-term by ensuring that Member States can deal with the budgetary pressures arising from ageing populations.

- *Providing the right incentives through tax and benefit systems.*
  By influencing people{{PU2}}s and businesses{{PU2}} decisions on work, saving and investment, tax and benefit systems affect the functioning of the real economy. The social protection system helps correct market failures by providing insurance against unemployment and illness and cover for old age, thereby promoting a more efficient allocation of resources. A well designed social protection and assistance system ca omic efficiency and be conducive to growth and employment. However, while correcting for market failures, badly designed social protection systems could introduce other distortions. In particular, they could have a negative impact on the supply and demand for labour. The combination

of high taxes and means-tested benefit withdrawal with unconditional and generous unemployment benefits over a long duration may lead to benefit dependency and unemployment traps at the lower end of the wage scale, especially if they are not supplemented by job placement support and monitoring of availability for work. In this context, reducing the tax burden on labour can be an important contribution to raising potential output and employment. Overall, concrete experiences in Europe and abroad support the view that reforms of tax and benefit systems, including the way in which benefits are administered, can increase participation and employment rates and reduce dependency.

- *Investing on productive factors*
  . Governments contribute directly to growth and employment by enhancing factor accumulation. Investment in physical (infrastructures), human (education and training) and knowledge (R&D and innovation) capital, if well-designed, affect long run output and growth potential, above all through their beneficial effect on productivity and activity. However, if higher public investment is financed through a rise in taxes or if it results in increases in deficits and consequently higher public debt, it may crowd-out private investment.

The remainder of this joint report focuses on each of these channels in turn. It summarises the assessment of recent progress by Member States made in the Commission Communication on the contribution of public finances to growth and employment. It also outlines future challenges and sets down proposals for policy actions by the Commission and Council.

3. Maintaining sound public finances in EMU

3.1 A framework for prudent budgetary management in EMU

Recent budgetary developments indicate that the EU is on the right track. Most Member States are within reach of the Stability and Growth Pact (SGP) goal of "*close to balance or surplus*". Moreover, while still at relatively high levels in some Member States, public debt is on a steady downward path, and reforms are being introduced to lower the tax burden from historically high levels. Overall, this is a considerable achievement bearing in mind that the deficit for the EU as a whole was at 6% of GDP only seven years ago.

While budget positions have returned to a broadly stable path, there is no room for complacency. The framework for fiscal policy in stage 3 of EMU has yet to be severely tested in a major economic downturn. Also, budgetary stability has been achieved with a tax burden at historically high levels. Where Member States have achieved sound budget positions, the challenge today is to sustain them while at the same time lowering tax burden, strengthening public investment in physical, human and knowledge capital, and preparing for the budgetary consequences of ageing populations. Having demonstrated a capacity to undertake fiscal consolidation in the run-up to EMU when the economic environment was less than favourable, Member States must now demonstrate their continuing willingness to pursue responsible fiscal behaviour during {{PU1}}good{{PU2}} times.

The Commission and Council therefore agree that the existing stability-oriented framework for fiscal policy at EU level must be consistently applied and developed to address the new budgetary challenges that are coming to the fore. This can be achieved by a prudent budgetary management in EMU which encompasses the different time-horizons of budgetary objectives as follows:

- *as regards short-run objectives*
  , while reaching and maintaining the goal of budgets "close to balance or surplus" in a sustainable way in each Member State, we must avoid repeating past policy mistakes of pro-cyclical fiscal policies and let automatic stabilisers work in order to avoid deterioration in structural balances.

- *as regards medium-term objectives*

, we need to ensure that fiscal policy choices on taxes and spending maximise their contribution to growth and employment, while achieving a sustainable reduction in the tax burden and sustaining public investment in physical, human and knowledge capital.

- *as regards long-run objectives*
  , we must ensure the sustainability of public finances in light of ageing populations. This has implications for current budgetary policies, because there is a "window of opportunity" during the next 5-10 years to prepare our economies before the demographic pressure builds up.

2. The short-run challenge: avoiding pro-cyclical fiscal policies

In periods of high growth, buoyant revenues and lower social security expenditures (especially unemployment benefits) should lead to smaller budget deficits or even surpluses; in economic downturns, a deterioration of the budget balance should normally occur. The symmetrical working of these automatic stabilisers helps smoothen the cyclical fluctuations of the economy in booms and recessions. Furthermore, budgetary targets should take into account not only cyclical factors, but also i ncorporate a safety margin for unforeseen fiscal developments not linked with the working of built-in stabilisers.

Graph 1. Budgetary imbalances in the EU 1977-2002

Source: Commission services

However, as illustrated on graph 1, EU public finances in the past have not always behaved in this desirable fashion. Deficits did not fall as expected during periods of high economic growth (illustrated by the shaded areas), implying that countries offset the working of the automatic stabilisers via discretionary tax cuts and/or expenditure increases. As a consequence, public debt continued to rise. Such fiscal relaxation in good times in turn necessitated a budgetary tightening during e conomic downturns to prevent an explosion of deficits and debt. Instead of smoothing the business cycle, fiscal policies accentuated the cyclical swings.

Avoiding pro-cyclical fiscal policies, consistent with the Stability and Growth Pact, is a sound principle for prudent budgetary management. Firstly, a pro-cyclical loosening in good times could mean that there is insufficient scope for the automatic stabilisers to fully operate in the event of an economic downturn. Countries may have to tighten budgetary policies when economic conditions are unfavourable so as to avoid breaching the 3% deficit reference value as required under the Stabil ity and Growth Pact: this could prolong the downturn and exacerbate the negative effects on employment. Secondly, given that the monetary policy is now set for the euro area as a whole and not available anymore as an instrument available at national level, other policies, including budgetary policy, should be used more flexibly. In countries with a strong positive output gap, the monetary policy stance may be overly accommodating. In such circumstances, it is important that Member States do not fuel risks o f overheating by running pro-cyclical budgetary polices which further increase aggregate demand.

Two key aspects of prudent budgetary management are:

- *a clear commitment to avoid past policy mistakes of pro-cyclical policies*
  : The Stability and Growth Pact requires Member States to have medium-term budget positions of "*close to balance or in surplus*" that will allow them to deal with normal cyclical fluctuations without breaching the 3% ceiling. The Council and the Commission affirm that each Member State will continue the consolidation of public finances to reach the goal of "close to balance or surplus& quot; in a sustainable way and avoid past policy mistakes of pro-cyclical policies.

- *using cyclically-adjusted budget balances:*
  the cyclically-adjusted fiscal position should be used as an additional tool when assessing Member States' budgetary positions. The cyclically-adjusted budget balance measures what the budget balance would be in the absence of cyclical fluctuations, i.e. it removes the effect of economic growth from the actual budget balance, and is an approximate indicator as to whether changes in budgetary positions are due to fluctuations in econom ic activity or to discretionary policy choices on the part of the government. However, the measurement of cyclically-adjusted balances is subject to a number of uncertainties stemming from the estimation of the position in the cycle, e.g. the magnitude of output gaps, and the size of the automatic stabilisers. Therefore, further efforts are needed to develop measures and criteria for assessing the impact of the fiscal position on the economy. The Council and the Commission propose that the Economic and Fina ncial Committee, in co-operation with the Economic Policy Committee, further refine methods to assess fiscal policy and output gaps in Member States; a full report in this issue is expected to be adopted by the Autumn of 2001.

1. The medium-term challenge: sound public finances to promote growth and employment

With budget positions approaching the "*close to balance or in surplus*", many Member States have outlined plans to reduce the overall tax burden and to reform tax systems. These developments, along with enhanced productive investment in physical, human and knowledge capital could make an important contribution to raising potential output and employment. Higher growth and employment will reduce unemployment benefits and make room for productive expenditures. Moreover, maint aining downward pressure on debt ratios will help reduce vulnerability to shocks and lead to lower interest expenditures. In effect, it is essential to get the right balance between a sustainable reduction in the tax burden, investment in public services and further fiscal consolidation so as to promote economic growth and social cohesion. This balance may differ between Member States. It would be counterproductive to make tax cuts now, only to find that they are not sustainable over the cycle and have to b e reversed during a future economic downturn.

Experience shows that tax cuts are not fully self-financing, and need to be accompanied with spending reforms. The extent to which tax cuts should be matched with expenditure reductions should be guided by the goal not to impose any economically undesirable additional burden from that decisions onto future generations through higher deficits. The necessary amount of expenditure reductions has to be gauged by the starting budgetary and cyclical economic position, as well as the degree to w hich tax cuts target supply side rigidities, whether public investment in physical and human capital needs to be strengthened. As regards the tax reforms currently underway, there appears to be a need for them to be accompanied with a firm control on government expenditure. Reduced expenditure must, however, not be made at the expense of necessary investments in physical, human and knowledge capital.

In order to make a positive contribution to growth and employment, tax reductions should be focussed on areas where they have beneficial supply side effects, and complemented with reforms to benefit systems to improve incentives for employment and entrepreneurial activity.

An appropriate balance also has to be drawn between cutting taxes and running down government debt and/or improving the long-term sustainability of public finances. Especially Member States whose public debt

remains above, or is close to, the 60% of GDP reference value, particularly those with high fiscal risks from ageing populations, should give priority to debt reductions. This will help reduce the vulnerability of the public finances to economic shocks and promote sound and sustainabl e public finances.

The Commission and Council agree that an assessment of the balance between sustainable tax cuts, productive public investment and the reduction of debt is needed to reinforce the contribution of public finances to growth and employment. The Commission and the Council agree that this assessment should take place both in the framework of the Broad Economic Policy Guidelines, and in the examination of updates to stability and convergence programmes.

3.4 The long-term challenge: sustainable public finances in light of ageing populations

Significant pressure on public finances due to ageing populations

In the coming decades, the population of current EU Member States will undergo substantial changes in size and age profile. Recent Eurostat population projections show that the EU working age population (aged between 20 and 64) will stay broadly stable at some 230 million persons until 2015, but thereafter fall to 192 million by 2050. At the same time, the number of elderly persons aged over 65 will rise from some 60 million persons in 2000 to over 100 million in 2050. This implies that t he EU will move from having almost 4 persons of working age for every one person of retirement age in 2000, to having less than 2 persons by 2050.

Graph 2. Old-age dependency ratio, 2000-2050

Source: Eurostat (baseline scenario). Note that old age dependency ratio is defined as persons aged over 65 as a percentage of working age population (aged 20-64).

Demographic changes of this scale will have profound economic implications. A decline in the size of the labour force coupled with a rapid increase in the old-age dependency ratio could lead to a lower rate of economic growth unless offset by increases in factor utilisation and productivity. Ageing populations could also have significant macroeconomic implications: although the evidence is mixed, aggregate savings throughout the industrialised world could fall, which in turn could lead to a rise in global real interest rates and a fall in investment.

However, the most pressing challenge is to address the significant pressures that will be placed on public finances. Projections made by the Economic Policy Committee show that notwithstanding reforms during the

1990s, ageing populations could lead to increased expenditure on public pensions of between 3 and 5 percentage points of GDP in most Member States in the coming decades leading up to 2050. Even in countries where the increase is expected to be relatively small, the level of pensio n expenditure will remain very high. Although projections must be interpreted with caution, available OECD and several Member States estimates suggest that spending on health care and care for the elderly could increase by some 3% of GDP due to ageing populations. Overall, public spending could rise by between 5 and 8 percentage points of GDP in Member States, with the risk of larger increases in event of less favourable demographic developments. On the other hand other public spending categories, e.g. expe nditure for family allowances might decrease. Work is under way in the Economic Policy Committee to get a more comprehensive picture of the effects of ageing on different spending categories and on assessing the overall impact on public finances and analysing cross country differences.

Table 1. Pension expenditure projections 2000-2050 (as % GDP, before tax)

	2000	*2020*	*2040*	*2050*	*Change 2000-peak year*
B	9.3	10.4	13.0	12.6	*3.7*
DK	10.2	14.0	13.9	13.2	*4.5*
D	10.3	10.6	14.4	14.6	*4.3*
EL	N.A.	N.A.	N.A.	N.A.	N.A.
E	9.4	10.2	16.3	17.7	*8.3*
F	12.1	15.0	15.8	N.A.	*3.9*
IRL	4.6	6.7	8.3	9.0	*4.4*
I	14.2	14.9	15.7	13.9	*1.7*
L	N.A.	N.A.	N.A.	N.A.	N.A.
NL	7.9	11.1	14.1	13.6	*6.2*
A	14.5	15.7	17.0	15.1	*3.1*
P	9.8	14.4	15.8	14.2	*6.2*
FIN	11.3	14.0	16.0	16.0	*4.7*
S	9.0	10.2	10.7	10.0	*1.7*
UK	5.1	4.4	4.4	3.9	*0.0*

Source Interim report of the EPC working group on ageing populations of 06.11.2000

Results for EL and L are expected in 2001

Ensuring sustainable public finances is therefore one of the most important budgetary challenges facing the EU. This is a particular challenge for countries maintaining a large stock of outstanding public debt (because of the need to sustain considerable primary surpluses) and for countries that face significant increases in public pension costs. Financing additional public spending on pensions and health care by running up large structural deficits and public debt is not an economically viable option, and moreover would be contrary to the Stability and Growth Pact and could undermine the smooth functioning of EMU. Simply raising taxes or pension contributions is equally not viable, as it would exacerbate disincentives to work and to hire workers and would widen inter-generation imbalances. Finally, cutting back on other essential public expenditure items such as infrastructure, education and training, information technology and R&D could be counter-productive to the extent that such ex penditures contribute to raising the potential output of the EU.

In brief, sustainable public finances not only require avoiding structural deficits and rising debt: they also imply keeping the tax burden (especially on labour) at levels such that employment and growth are not hindered, and also ensuring that essential public expenditures such as education and investment are not crowded-out by pressures for increased spending on pensions and health care.

A three-pronged strategy to tackle the budgetary implications of ageing populations

The scale of the phenomenon calls for a three-pronged approach to addressing the budgetary implications of ageing. Firstly, Member States in general should reduce public debt levels at a faster pace, thereby lowering the interest burden.

Illustrative calculations presented in the Commission Communication show that maintaining budgetary positions at the 2003 target levels would bring about a fall in their interest burden by 2020 of around 3 percentage points of GDP. These significant savin gs (which are largest for high-debt countries) highlight the contribution that fiscal discipline can make in pre-empting the budgetary consequences of ageing populations. However, since the potential saving are unlikely to fully compensate for additional age-related expenditures in many Member States, a long-term strategy of debt reduction needs to be complemented with other reforms.

The second element is a comprehensive labour market reform leading to higher employment rates: this would help offset the negative impact of demographic developments on the ratio of active to inactive persons. While measures are needed to raise employment rates across all age cohorts, particular attention should be paid to raising employment rates amongst older workers and women. Participation rates of men aged over 50 have fallen considerably in the EU in recent decades, and are l ow (for both men and women) compared with other industrialised countries. These developments cannot only be attributed to an increase demand for leisure as income increase. There is strong evidences that the tax and benefit system, combined with early retirement schemes, have led to a bias in favour of early withdrawal from the labour market, i.e. there is a large "implicit tax" on remaining in active employment until the official retirement age. Tax and benefit reforms must address this bias, and return neutrality to the decision as to when to retire. Active measures will also be required to improve access to life-long learning, facilitate the reconciliation of professional life and family life for example via the provision of affordable child care facilities. However, the simulations of the EPC have shown that even meeting the ambitious employment targets agreed in Lisbon will not by itself completely offset the economic and budgetary consequences of ageing populations.

Thirdly, ambitious reforms of pension systems are urgently required in many Member States not only to contain pressures on public finances, but also to redress intergenerational imbalances and to raise employment rates. Indeed, it is difficult to envisage how the Lisbon employment targets can be reached unless effective retirement ages across the EU rise substantially, something which can only be achieved through reform of all kind of early retirement schemes and of the pension and tax sy stem. PAYG pension systems need to be placed on a sound financial footing, *inter alia* to avoid increase in the tax burden on labour. Moreover, there is scope in some Member States to increase the share of public pension schemes that are funded.

Recent reforms of pensions are assessed in more detail in the Commission Communication. This issue will be discussed at the Göteborg European Council of June 2001. The Economic Policy Committee continues its work on the effects of ageing on public finances.

Overall, however, progress on pension reforms has been disappointing. Baring one or two Member States, little progress was made towards reforming pension systems during 2000. Dialogue and consensus amongst social partners are important for reforms to succeed. However, a disturbing pattern of repeated postponements is evident in many countries. Delays in reforming public pension systems will increase the cost of reform. In several Member States the establishment of a better legal and fisca l framework for funded pensions would help citizens to save for their retirement. Pension reform must now become a top priority in many Member States, and concrete progress must be made.

Addressing the economic and budgetary consequences of ageing populations at EU level

Addressing the economic, budgetary and social implications of ageing populations is one of the most important public policy challenges facing the EU. But it is also one of the most difficult and complex. As rightly emphasised by the Committee on Social Protection in their report to the Nice European Council, measures to achieve sustainable public finances must at the same time ensure the sustainability of social protection systems so that older citizens are provided with an adequate retir ement income and health care services. The Community must develop a mutually reinforcing approach which ensures both sustainable public finances and sustainable social protection systems. This is important also in light of the objective of the Göteborg European Council to devise a comprehensive strategy for sustainable development.

As regards the budgetary implications of ageing populations, the ECOFIN Council in a report to the Helsinki European Council on the co-ordination of economic policies called for *"a broadening of the scope of public finance issues covered in the stability and convergence programmes and more emphasis on medium to longer-term sustainability issues."* Some progress was made towards introducing long-term budgetary issues into the current updates to stability and convergence pro grammes. The scale of the budgetary impact of ageing populations, and the potential implications for the sound and efficient functioning of EMU, underlines the need for systematic assessments based on comparable data and indicators.

To this end, the Commission and Council agree that future stability and convergence programmes should contain a section on the long-term sustainability of public finances. Programmes should set down the fiscal dimension of the overall strategy of the government to address the budgetary consequences of ageing populations (where possible using long-term budgetary projections and comparable indicators to be developed at EU level). This would in no way alter existing commitments and would be fully in line with the principal purpose of programmes, namely to define a medium-term budgetary strategy. Besides, the Commission and Council agree that the more detailed strategy of governments to address the economic and budgetary consequences of ageing populations, and the outlines of actual or planned reforms, should be assessed in the framework of the Broad Economic Policy Guidelines and the multilateral surveillance procedure. Presenting the strategy to address the long-term sustainability of public finances would in addition (1) underline the fact that Member States have an obligation to respect the Stability and Growth Pact over the long-term, (2) emphasise the need for policy actions well in advance of the major demographic changes, and (3) ensure that Member States balance the need to prepare for ageing populations into current policy choices such as debt reduction and tax and benefit reforms.

More reliable and comparable data/indicators are essential if the long-term sustainability of public finances is to be properly assessed at EU level. To this end, the ECOFIN Council has requested the EPC to continue its work on ageing populations. Regarding pensions, the interim report submitted by the EPC in November 2000 constitutes a good basis for future work, but more efforts are necessary to increase the comparability of national projections and to get a fuller picture of the budget ary effects of ageing. To this end, the EPC, in close cooperation with the Commission and in consultation with the Social Protection Committee, is requested to provide an assessment of the impact of ageing on public spending on health care and long-term care for the elderly, and to report to the Council at the end of 2001. A comprehensive report assessing the overall impact of ageing on public finances, including the effects on tax systems, should be submitted in 2002. On this basis the EPC and the EFC shou ld examine the merits of possible indicators for the long-term sustainability of public finances. The EPC has also been invited to examine the relative merits of different pension systems and intends to report to the Ecofin Council in 2002. The EPC should prepare an interim report in time for the Barcelona Summit in Spring 2002. Finally, the ECOFIN Council will examine the merits and feasibility of establishing a longitudinal survey on ageing based on an assessment of the Commission.

4. Towards more employment-friendly tax and benefit systems

Some progress in making tax systems more employment friendly

Tax reforms in recent years have focussed on the need to reduce the tax burden on labour, which increased by one-third in the past 30 years. As measured by the implicit tax rates, the overall tax burden on employed labour in the EU has steadily increased from less than 30% in 1970 to a peak of 42% in 1996-97. This tax burden on labour is very high by international standards, and is mainly due to higher social security contributions.

Some progress was made towards making tax systems more employment-friendly, by lowering the fiscal burden on labour as well as reducing marginal tax rates. Commission forecasts project the implicit tax rates on employed labour falling by more than 1 percentage point in the EU between 1999 and 2002. Moreover, the reforms introduced or announced to date mainly concern direct taxes, which typically have large distortionary effects.

Table 2. The tax burden on low and middle wages

	Single individual **(no child, earning 67% of the APW*)**		**married couple** **(two children, but single earner APW*)**	
	Implicit tax rate in 1999	**Change** **1997 to 1999**	**Implicit tax rate in 1999**	**Change** **1997 to 1999**
B	51	2	41	2
DK	41	-1	31	0
D	47	-1	35	-1
EL	35	0	37	1
E	33	-2	30	-3

F	40	-1	39	-1
IRL	22	-3	20	-4
I	44	-5	37	-6
L	30	0	11	-2
NL	40	2	34	1
A	42	1	32	0
P	30	-1	26	-1
FIN	43	-1	40	-1
S	49	0	45	-1
UK	26	-2	24	-1
US	29	1	25	0
JAP	18	-1	15	-1

The tax burden on labour is defined as income tax plus social security contributions less cash benefits as % of labour costs. The figures for 1999 are estimates which may not take account of eventual reforms introduced during that year.

Source OECD.

However, reform efforts have been unequal across Member States with a comprehensive approach to reform the tax system in some countries contrasting with a piecemeal approach in others. Nonetheless, some common directions in EU tax policies can be identified. Cuts in social security contributions are generally being targeted more at employers than at employees. Most Member States have already implemented or have announced initiatives to cut personal income-taxes.

Although most reforms provided for generalised reductions in taxes, some countries clearly targeted reductions at low-paid families with children. Finally, tax-shifting away from labour to other tax bases such as consumption has been very limited, although a lowering of social security contributions is being partially financed by an increase in indirect taxes in some Member States.

Progress in making benefit reforms more employment friendly

Compared with taxes, much less progress have been made to reform benefit system. As documented in the Commission Communication (see chapter 4.1), reforms of unemployment benefit schemes have mainly involved tighter controls on eligibility requirements and improved administration of benefit schemes. There has also been some tendency to increase in-work or employment related benefits, such as targeted wage subsidies, tax credits and/or benefit transfers to the employer recruiting an unemplo yed person. Some countries have also made efforts to encourage part-time work instead of unemployment, mostly by means of relaxing conditions for part-time unemployment benefits. A further positive development is that after a long period when early retirement was the norm, most Member States have reformed schemes so as to induce older workers to prolong their working life.

*Table 3. Net replacement rates at 67% of the average wage level, 1997**

	Married couple, 2 children,1st month of unemployment	Single earner, 1st month of unemployment	Married couple, 2 children, 60th month of unemployment	Single earner, 60th month of unemployment
B	75	84	79	61

DK	95	89	92	67
D	74	69	61	75
EL	48	55	5	0
E	78	70	61	35
F	86	83	60	55
IRL	73	45	73	45
I	52	36	75	39
L	85	80	91	67
NL	90	92	94	84
A	79	57	76	54
P	86	87	86	61
FIN	94	72	100	79
S	90	77	100	84
UK	83	73	95	73
US	51	59	61	10

* After tax and including unemployment benefit (unemployment insurance and unemployment assistance), family and housing benefits. Figures for benefits in the 60th month include social assistance in a number of countries. There can be large differences across countries as regards coverage and duration of benefits.

Source: OECD

In general, however, changes in net replacement rates have been relatively small, while only few Member States have developed in-work benefits to boost earnings of low-paid workers. Net replacement rates for low-paid workers remain relatively high in several countries which may lead to unemployment traps.

Meeting the challenges

Overall, insufficient progress has been made towards making tax and benefit systems more employment friendly. High average and marginal tax rates on labour income combined with too passive and generous benefit systems continue to have adverse effects on the functioning of the labour markets in particular. The interaction of tax and benefits systems still leads to low participation and increases the risks of unemployment and poverty traps. In order to reduce distortions, enhance participat ion and increase the supply and demand for labour, the European Council is invited to recommend that Member States pursue, notwithstanding the principle of subsidiarity, long-term strategies to reform tax and benefit systems encompassing the following elements:

- further pursue the reduction of labour taxes, particularly at the bottom end of the wage scale, and improve the incentive structures in tax- and benefit systems in a context of sound public finances;
- improve the efficiency of tax systems by simplifying tax codes and broadening tax bases. In particular; high effective marginal tax rates for low and middle incomes have to be avoided in order to enhance skills acquisition;
- reinforce and intensify the shifting from passive to well-designed active labour market policies in the context of the Luxembourg process;
- further improve the administration of unemployment schemes, while ensuring that benefit entitlement conditions support participation in active labour market programmes;
- eliminate fiscal disincentives for taking-up part-time jobs and for part-time workers to take full-time jobs.

5. Public finances for a knowledge-driven economy

Only a partial response to the Lisbon mandate

The Lisbon European Council called for an assessment of Member States{{PU2}} efforts to redirect public expenditure towards capital accumulation, both physical and human, and to support research and development, innovation and information technologies. These public expenditure items make a direct contribution to meeting the strategic goal of moving towards a knowledge-driven economy. Moreover, they are directly related to the ongoing debate on the so-called "new" economy.

However, there is a lack of data on both inputs used by the public sector (as different countries record and classify them in different manners) and outputs (the efficiency and economic benefits of such expenditures). This has limited the assessment in this joint report to three areas, namely public investment in physical capital, public investment in human capital and public spending on R&D and innovation, which only goes part of the way to meeting the mandate of the Lisbon European Council.

The assessment only focuses on the overall level of public expenditures. However, in addition to the amount of public spending, account should be taken of institutional differences across countries, and especially the relationship between public and private investment. In the end, what counts for growth is *total* capital accumulation and not just *public* capital accumulation. A low level of public capital accumulation in a particular field (e.g. R&D) may be offset by a hig h level of private sector capital accumulation.

In this sense, providing a proper incentive structure for private agents is at least as important as direct public sector intervention. Public expenditure should be complemented by institutional and structural reforms in order to ensure an efficient use of government expenditures, enhance the role of market mechanisms, improve the regulatory framework, ensure a sufficient supply of trained manpower and introduce adequate incentive systems to promote private accumulation of physical and hu man capital. Finally, spending in the form of state aids needs to be carefully controlled to ensure that it does not delay necessary restructuring or protect enterprises from the effects of market developments.

The Commission and Council agree that efforts to redirect public expenditures should be made in a framework of sound fiscal policies so as to keep the tax burden on a sustainable path and to enable countries to prepare for ageing populations. To meet the objectives of the Lisbon European Council, efforts to enhance capital accumulation must to a large extent come through expenditure restructuring to prevent fiscal imbalances from re-emerging. Furthermore, restructuring of public spending should be complemented by institutional and structural reforms in order to optimise government spending, enhance the role of market mechanisms and introduce adequate incentive systems to promote private accumulation of physical and human capital. It is through a balanced combination of spending restructuring, tax policies, and structural reforms that the EU can meet the Lisbon challenge.

Investment in physical capital

Despite the large increase in total public spending over the past 40 years, government investment as a share of GDP dropped from above 4% in the 1960's and early 1970's to below 2% in the late 1990s. In 2000, it is expected to reach a minimum of 1.8% of GDP. Commission forecasts suggest that the continuous fall in the share of public investment has been brought to a halt and even reversed in some countries. For the EU as a whole, a slight increase of public investment spending is projecte d between 1999 and 2002.

However, these changes in public investment should be interpreted with caution. The falling share of public investment in recent decades can partly be attributed to an increased recourse to market based solutions, e.g. the privatisation of commercially viable operations and a more direct involvement of the private sector in the production and provision of public services. A declining share of public investment may have been offset by increased private investment. Nonetheless, the recent t rend towards increased levels of public investment is welcome, especially as it has been combined with efforts to increase efficiency via the introduction of market mechanisms in the search for greater efficiency and value for money. Methods include internal pricing, budgetary targeting and market price oriented fees. Additional efficiency gains can be achieved by effectively implementing Community rules on public procurement and increased recourse to "Public-Private Partnerships" (PPP).

Source: Commission services

On the basis of available data, it is not possible to assess whether the aggregate level public investment is adequate. It would appear, however, that public investment needs to be maintained at current levels or in some cases increased to meet future needs arising from (1) the widespread introduction of information technologies that will oblige various types of infrastructure to be upgraded, (2) the integration of environmental considerations (infrastructure will have to adapt to new req uirements and especially to consume less energy so as to reach Kyoto objectives) and (3) enlargement given the need to reinforce the East-West and North-South dimensions of various types of infrastructure. Moreover, Member States with low levels of public investment and poor capital stock should strive to increase the quantity and quality of investment in order to promote productivity and economic growth.

Investment in human capital

Education in the EU has been traditionally funded by governments, and public spending in 1997 amounting to 5% of GDP on average (see table 5.1 in the Commission Communication). This figure has been fairly stable in recent years given the maturity of education systems.

Of course, education is not the only means to increase human capital accumulation. Training in enterprises constitutes one of the main elements of human capital development, and is paramount in times of fast technical progress. Training has become a key element in the European employment strategy, as set up in the Employment Guidelines where vocational training and a comprehensive approach to life-long learning is a major goal. Such efforts are assessed every year in the Joint Employment Report. Evidence from the National Employment Action Plans shows that all Member States have started to promote education and lifelong learning activities. Several Member States have acknowledged that education and training deficits do exist, and the need to adapt training provisions and to launch specific measures to improve qualifications.

As regards training and life-long learning, further efforts are needed by both the public and private sector to upgrade professional skills. Available statistics on participation in labour market training and education activities still paint a rather disappointing picture. Participation rates among adults (25-64 years old) remain low in the EU, although they have somewhat increased in recent years, from 6.5% in 1997 to 8% in 1999 (see table 5.2 in the Commission Communication).

To promote the goal of a knowledge based society, governments must put more emphasis on education and training in order to offer European citizens the opportunities and incentives to acquire the necessary knowledge, skills, and competence, for them to be able to adapt to the rapidly changing patterns of living, learning and working environment. The Employment Guidelines invite Member States to set targets for increased per-capita investment in human resources. In particular, governments h ave to reinforce their efforts in the fields vocational training and life-long learning, while taking into account the cost-effectiveness of different policies.

R&D and innovation

Governments spending on R&D as a percentage of GDP is broadly similar in the EU and US. However, the industrial research effort in the EU is only 60% that of the US, a difference which is especially relevant for the development of the "new" economy. Whereas the Federal Government funds 13% of the R&D expenditure of American companies, only 9% of private R&D expenditure in the EU is publicly funded. Overall, the total research effort in the EU is less than 2% of GDP c ompared with 3% in the US.

As well as R&D, the importance of innovation has been unambiguously highlighted in the European Council of Lisbon as a response to the challenges of globalisation and the knowledge-driven economy. In order to offer an environment supportive of innovation, the regulatory, administrative and financial environment is important, and special emphasis should be attached to improving the interfaces in the research and innovation system. This will allow firms to have access to knowledge, skil ls, financial banking, sources of advice and market information.