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COMMISSION OF THE EUROPEAN COMMUNITIES

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COMMISSION STAFF WORKING PAPER

COUNTRY NOTES

Annex to the

Report from the commission on the implementation of the 2001 Broad Economic Policy Guidelines

{COM(2002)93 final}

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1. BELGIUM

1.1 Macroeconomic context

1. Economic activity decelerated in 2001, after exceptional buoyancy in 2000, when real GDP growth reached 4.0%. The slowdown has been driven by a decline in private consumption and investments and by a negative contribution of net exports resulting from the deteriorating external environment. Real GDP growth is estimated, according to latest data, at 1.1% for 2001. Labour market outcomes were rather positive until September 2001, the standardised unemployment rate falling below 7%. Since then there has been a slight increase in unemployment. In line with the deterioration of the economy, employment has been growing at a much slower pace than the 1.6% rate averaged in 2000. Employee earnings have increased rapidly in 2001 based on a generous framework agreement. After having peaked at 3.1% in May due to high food and oil prices, the HICP has been on a declining trend and averaged 2.4% in 2001.

Table 1.1: **Economic developments in Belgium**[1)]

	1992-97	1998	1999	2000	2001
Real GDP	1.7	2.2	3.0	4.0	1.1*(1.3)
Domestic demand	1.3	3.3	2.2	3.8	(1.6)
Private consumption	1.2	2.9	2.1	3.8	(2.0)
GFCF (Investment)	2.0	4.3	3.3	2.6	(-0.6)
Exports (G&S)	4.3	5.8	5.0	9.7	(0.7)
Imports (G&S)	3.9	7.5	4.1	9.7	(1.0)
Inflation [2)]	1.9	0.9	1.1	2.7	2.4
Compensation/employee	3.4	1.8	3.2	3.2	3.2

Note: Data in this and subsequent tables are based on the Commission services' Autumn 2001 Economic forecasts. Where these data have been replaced by more up-to-date figures, these new data have been marked with an asterisk (*). If this resulted in an inconsistent dataset due to an incomplete update, the original Autumn 2001 forecast figure is shown in brackets.
- none
: not available
1) Annual percentage change.
2) Harmonised index of consumer prices.
Source: Commission services.

1.2 Key challenges

2. Whereas Belgium made progress in implementing the recommendations of the 2001 BEPGs, a number of key policy issues require continued attention, in particular the still very high government debt-to-GDP ratio, the low employment rate, the high regional differences in unemployment, the lack of competition in specific service sectors and the efficiency of the public administration.

Key economic policy challenges for Belgium

- Reducing the still very high government debt-to-GDP ratio, particularly in connection with future challenges stemming from the ageing population.
- Increasing the low employment rate, especially for older workers.
- Tackling the persistently high regional differences in unemployment.
- Addressing the lack of competition in specific service sectors (e.g. the energy and transport sectors) and improving the efficiency of the public administration.

3. Public finances have improved greatly in recent years. The budget deficit has disappeared and the debt-to-GDP ratio has fallen constantly. The general government deficit, which stood at 8% in 1992, turned into a small surplus in 2000 and 2001. The debt-to-GDP ratio fell 31 percentage points between 1993 and 2001, but remains very high at 106.9%. Moreover, a further reduction of the public debt is necessary in view of population ageing, which will start to weigh more heavily on the budget from 2010 onwards. It is estimated that public spending on pensions and on health care will increase by 3.7% of GDP and 2.1% of GDP respectively. Large primary surpluses will therefore have to be sustained over the long run in order to meet the budgetary costs of ageing populations.

4. The employment rate has been growing steadily over the second half of the 1990s, rising from 56.3% in 1996 to about 61% at the end of 2000. Yet, it is still below the EU average, mainly because of the low employment rate for older workers (55-64 year-old) – the lowest in the EU in 2000 – and the relatively lower rates for youngsters (15-24 year-old) and women above 40 year-old. Although some measures have been taken to address the problem of benefit dependency and to reduce the risk of "unemployment traps", there is still a sizeable number of working-age benefit recipients, especially older workers. The work disincentives of the current benefit schemes, mainly unemployment benefits and early retirement, are still high.

5. Regional disparities in unemployment remain significant. In 2000, unemployment stood at 4.3% in Flanders, 10.3% in Wallonia and 14% in the Brussels region. The employment rate in the Flanders (about 64%) was 8-9 percentage points higher than in Wallonia and the Brussels region. Labour mobility and commuting toward Brussels is high, but remains generally rather low from Wallonia to Flanders. Linguistic barriers, high housing costs (due to heavy registration taxes), increasing traffic congestion, an inadequate public transportation network, appear to be the main obstacles to mobility. Benefit systems (in particular eligibility criteria and their administration) also play a role.

6. Service sectors have long been depicted as suffering from insufficient competition. Although steps have been taken to foster the powers and resources of competition and regulatory authorities, competition is still weak in several sectors such as energy and transport. The involvement of local authorities in services as diverse as retail of electricity and gas, television cables, architecture, building and civil engineering, tourism, travel, banking, etc. pose potential problems to the safeguarding of competition. Efforts to simplify and reduce the administrative burden have been sizeable but time and cost requirements to register a company remain high in comparison to other EU countries. Some measures have been taken to improve the

efficiency of public administration, in particular by developing e-government. However, the reform of the federal public administration (Copernicus) has been delayed.

1.3 Public finances

7. Belgian public finances have improved greatly in recent years, although the government debt-to-GDP ratio remains sizeable. For the first time since 1950, the general government balance turned into a small surplus in 2000 and 2001. Debt reduction is a clear priority and thanks to high primary surpluses, the debt-to-GDP ratio has been decreasing rapidly: compared to the 1993 peak of 138.1% of GDP, it reached 109.3% in 2000 and is estimated at 106.9% in 2001.

8. Despite the marked slowdown in the economy in 2001, public finances were kept under control. The 2001 budget was based on cautious macroeconomic assumptions (2.5% real GDP growth) and the government took additional measures during the July extraordinary budgetary control exercise in order to offset rapidly growing health care expenditures and earlier-than-anticipated indexation of salaries and social security benefits due to accelerating inflation at the beginning of the year. The decline in interest rates has also limited the impact of the slowdown of the economy on public finances.

9. Some progress was made in implementing the 2001 public finance recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendations in the 2001 BEPGs	*Degree of implementation*
➢ Achieve a budgetary surplus of 0.2% of GDP as projected for 2001 in the 2000 update of the stability programme, even in the event of slower real GDP growth than projected.	2
➢ In the framework of the budget for 2002, contain firmly the annual increase in primary expenditure within the 1.5% limit, in real terms, in Entity I, thus allowing the achievement of the government balance objectives, in particular a primary surplus above 6% of GDP.	Partial
➢ In 2002 and beyond, allocate the budgetary margins, as defined in the 2000 update of the stability programme, in a way consistent with the limit of 1.5% growth of real expenditure; allocate all additional budgetary revenues which might result from better than expected real GDP growth to debt reduction.	In progress
➢ Prepare for the budgetary implications of population ageing by timely reform of the pension system, including the identification of the budgetary resources to be allocated annually to the 'Ageing Fund', in the next update of the stability programme.	In progress
The degree of implementation is indicated as: “2” for (practically) complete; “in progress” where progress on implementation is well advanced but still incomplete or where it is too early to assess whether the measures taken fully meet the objectives of the recommendation; “partial” where progress made is clearly insufficient either because not all parts of a recommendation have been addressed or because they have not been fully addressed; and “no new measures” where there have been no substantial new measures over the last year that go in the direction recommended.	

10. A budgetary surplus of 0.2% of GDP was achieved in 2001 (including 0.2% of GDP receipts from UMTS licences) according to an official estimate presented on 4 January 2002. This result was achieved despite a strong deceleration in economic activity.

11. The 2002 budget limits primary expenditures within a target of 0.5% in real terms for the Federal government. Social security expenditures are expected to grow by 2.6% in real terms. Based on the 2002 budget, the projected increase for Entity I (federal government and social security) is 1.8% in real terms in 2002. The general government accounts are expected to be in equilibrium, as against a surplus of 0.3% of GDP projected in the 2000 stability programme. The government has already announced that two budgetary control exercises will take place in 2002. Health care expenditure has risen well above the 2.5% benchmark in real terms in 2001; rising unemployment in 2002 will probably further weigh on the social security accounts. Thus, strict control of primary expenditures will be necessary to reach the budgetary objective. A primary surplus of 6% of GDP is projected in the 2001 stability programme.

12. As a medium term objective, the federal government has committed itself to respect the 1.5% limit in real growth for primary expenditure for which it is responsible. In the 2002 budget and the 2001 stability programme, the government has reaffirmed its strategy to allocate additional budgetary revenues which might stem from better than expected real GDP growth to debt reduction. In the 2001 stability programme, government primary surpluses are projected to decline progressively over the period to 2005, below the level of 6% of GDP in 2004 and 2005.

13. In the 2001 updated stability programme, the budgetary resources to be allocated to the 'Ageing fund' have been clearly identified, and the amounts for 2002 will be set at the same level as in 2001. The 'Ageing fund' is allowed to invest only in government bonds until the debt ratio falls below the GDP level. The pension reform is limited until now to supplementing the statutory pensions on a sector-based level.

Table 1.2: **Trends in public finances in Belgium** [1)]

	1994	**1996**	**1998**	**1999**	**2000**	**2001**
Government balance [2)]	-5.0	-3.7	-0.8	-0.6	0.1	0.2*
- Total revenue	48.7	49.1	49.8	49.7	49.5	(49.1)
Tax burden [3)]	45.6	45.4	46.2	46.0	45.9	(45.9)
- Total expenditure	53.7	52.8	50.7	50.3	49.4	(49.1)
Primary current expenditure	41.7	41.9	40.8	40.6	40.0	(40.5)
Interest payments	9.6	8.8	7.5	7.0	6.8	6.5*
Investment	2.0	1.6	1.6	1.8	1.8	(1.5)
Primary balance [2)]	4.6	5.1	6.7	6.4	6.8	6.7*
Government debt	136.4	130.1	119.3	115.0	109.3	106.9*
Cyclically-adjusted balance [4)]	-4.3	-2.7	-0.5	-0.7	-1.0	(-0.7)
Cyclically-adj. primary balance [4)]	5.3	6.2	7.0	6.4	5.8	(5.8)

1) Per cent of GDP.
2) Including proceeds relative to UMTS licenses.
3) Total tax burden excluding imputed social security contributions.
4) Excluding proceeds relative to UMTS licenses.
Source: Commission services.

1.4 Economic reforms

1.4.1 Labour markets

- **Overall assessment**

14. The rapid decline in the unemployment rate gradually came to a halt in 2001 (at around 7% of the labour force), as a result of weaker economic growth. Regional disparities in unemployment remain considerable, with the unemployment being more than twice as high in Wallonia as in Flanders. In addition, the employment rate for older workers is very low, partly explained by relatively strong disincentives to work in some benefit schemes.

15. Some progress was made in implementing the 2001 labour market recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendations in the 2001 BEPGs	*Degree of implementation*
➢ On the basis of past reviews, reform further tax and benefit systems to make work pay, in particular, to create adequate incentives for older people to continue to work or re-enter the labour market and to revise the special arrangements exempting older unemployed people (aged over 50) from active job search.	In progress
➢ Address the main obstacles to labour mobility and encourage social partners to allow wage-setting mechanisms to take better into account productivity and local labour market conditions, while preserving wage moderation.	Partial
➢ Continue to enhance, together with the social partners, labour market flexibility by further relaxing conditions for fixed term and temporary contracts and increasing working-time flexibility, while ensuring that any reduction in working time has no adverse impact on unit labour costs and labour supply.	In progress

16. Efforts were made to reform tax and benefit systems. However, as envisaged by the interprofessional agreement in December 2000, there has been no change in the age limit (58 years) for the "collective early retirement scheme". Yet, some changes occurred in the scheme for older unemployed persons. Since 1st January 2002, new older unemployed people (between 50-55 years) are covered by the prevention/activation measures of the employment services and they have the same duties as other unemployed persons (obliged to take-up a "suitable" job). A number of initiatives were undertaken to combat unemployment traps for low-skilled people. The introduction of a refundable tax credit for low-income earners, although only small in size (496.3 € per year), has moderately increased incentives to take up job for low-skilled people, thereby addressing the problem of benefit dependency. Yet, more targeted reforms are needed to help reduce the risk of unemployment traps.

Table 1.3: **Labour market indicators for Belgium**

	Belgium					EU			USA		
	1990	1994	1999	2000	2001	1994	2000	2001	1994	2000	2001
Employment rate (ER) 1)	54.6	55.7	59.3	60.5	:	59.6	63.2	:	72.0	74.1	:
Female ER 1)	40.9	44.6	50.4	51.5	:	49.3	54.0	:	65.2	67.9	:
Older workers ER 1)	21.5	22.4	24.6	26.3	:	35.7	37.7	:	54.4	57.7	:
Employment growth 2)	0.9	-0.4	1.4	1.6	1.2	-0.1	1.7	1.1	2.3	1.9	-0.1
ER full time equivalent	:	53.2	55.6	57.5	:	54.9	57.9	:	:	:	:
Unemployment rate (UR)	6.7	10.0	8.8	7.0	6.9	11.1	8.2	7.8	6.1	4.0	4.8
Long-term UR 1)	4.8	5.6	4.9	3.8	:	5.2	3.6	:	:	:	:
Youth UR (<25)	15.3	24.2	23.7	17.7	17.4	22.1	16.2	15.5	12.4	9.3	10.6
Nominal wage growth 2)	7.7	4.1	3.2	3.2	3.2	3.1	3.0	3.3	2.4	5.1	5.3
Real Unit Labour Cost growth 2)	2.5	-0.9	0.4	-0.6	1.0	-2.4	-0.1	0.3	-1.1	0.7	1.8
Labour Productivity growth 2)	2.0	3.2	1.6	2.4	0.1	2.9	1.6	0.5	1.5	2.1	1.0
Tax rate on average wage earners 3)	:	54.6	56.9	56.2	55.6	44.6	43.6	43.0	31.2	30.8	30.0
Tax rate on low wage earners 3)	:	:	51.0	49.9	49.1	:	38.6	37.8	:	29.0	27.7
NRR on low income families (married) 4)	:	60.0	59.0	:	:	72.0	67.0	:	59.0	59.0	:
NRR on low wage earners (single) 4)	:	84.0	83.0	:	:	71.0	68.0	:	59.0	59.0	:

1) From the Community Labour Force Survey. Data is adjusted, where appropriate, to provide an annual average as used for the Structural Indicators. The ER, female ER and older workers ER figures for USA are from OECD.
2) From Ameco (national accounts). Figures for 2001 are estimates from Autumn 2001.
3) Income tax plus employer and employee contributions, as a % of labour costs for a representative taxpayer (employee) - average rate. Average wage earners = single earner at 100% of the APW, no children. Low wage earners = single earner at 67% of the APW, no children. Source: OECD / DG TAXUD. 2001 figures are preliminary.
4) NRR: the net replacement rate figures are for 1995 and 1999 and relate to the 1st month of unemployment. Source: OECD. The 1999 figures are preliminary and are subject to final verification by Member States. Low income families = married, single income on 100% APW, 2 children. Low wage earner definition as per footnote 3.

Source: Commission services. OECD where footnoted.

17. No major measures appear to have been undertaken to promote greater wage flexibility. Yet, the latest intersectoral agreement allowed greater scope for wage differentiation at sectoral level. The current wage bargaining system is considered to be already sufficiently flexible by the Belgian authorities and the social partners do not seem to have a revision of the current mechanism among their top priorities.

18. Some measures have been undertaken to enhance labour market flexibility. Their impact on labour supply is still difficult to assess. Indeed, one of the main measures, the new time-credit system, which allows a better balance between working and family life, could reduce labour supply (worked hours) of employees. On the other hand, it could also increase the participation of those currently inactive. Furthermore, by allowing older workers to work half time or to adopt a four-day week, it provides incentives to postpone retirement.

1.4.2 *Product markets and the knowledge-based economy*

- **Overall assessment**

19. The Belgian economy's openness stimulates competition on the goods markets. Labour productivity is high and consumer price levels are in line with the EU average. However, competition problems remain in some services sectors such as energy. As a result, electricity prices are significantly above the EU average. The links between provincial or local public authorities and private partners still lack transparency in several sectors. Despite recent reforms to decrease red tape and increase the efficiency of public administration, the administrative burden remains sizeable, and so is the level of State aids, especially those targeted at railways.

20. On average, R&D and ICT expenditures are in line with the EU average and the internet is diffusing rapidly in households and at school. However, business R&D is extremely concentrated in a few sectors and firms. Competition in the local loop is still weak but broadband access is diffusing fast, thanks to cheap access costs. Low innovation in SMEs, the slow internet penetration in businesses, and the low number of graduates in sciences and technology are potential brakes for a rapid emergence of a knowledge-based economy. E-government initiatives have nevertheless the potential to increase public awareness.

21. Some progress was made in implementing the 2001 product market recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendations in the 2001 BEPGs	*Degree of implementation*
➢ Increase competition in transport and distribution of gas and electricity and set up independent transportation network managers in these sectors in order to ensure non-discriminatory access; ensure that the planned reform of the railways will increase efficiency and quality of service and reduce the need for operating subsidies.	Partial
➢ Increase the transparency of the links between the public and private sectors at the local and provisional level, especially the role of municipalities and their associations in different sectors such as energy, in order to avoid distortions of competition and conflicts of interest.	Partial
➢ Take measures to reduce and simplify the administrative burden on business.	In progress

22. The two incumbents that jointly owned the transmission grid dominate electricity generation. There have been delays in implementing the electricity directive and very few consumers have been able to change supplier. Despite an infringement procedure, the Transport System Operator (Elia) has not yet been officially designated. In practice, Elia is still a subsidiary of the incumbent, and competitors are complaining about discriminatory practices. Thirty-two associations of municipalities (intercommunales) enjoy a legal monopoly on the distribution and the retail of electricity, and carry out these activities in most cases in association with Electrabel through exclusive long-term contracts and capital ownership. The new federal regulator (CREG) operating on the

eligible segment will see its supervision extended to the non-eligible segment from 2003 onwards. Co-ordination between federal and regional regulators may be problematic in the future. Symptomatically, prices of electricity are significantly above the EU average. In the gas sector, Belgium speeded up the liberalisation schedule to 2006, but further legislative work is needed to fully implement the EU directive. The structure of distribution is similar to that in electricity, and there are cross holdings in both sectors. Transport and retail of gas have just been unbundled. The reform of the railways will change the structure of the National Railways Company (SNCB), open up the sector to private initiatives, and develop the infrastructure. However, state aids towards railways remain high.

23. Provinces, municipalities and associations of municipalities are very active in diverse sectors such as distribution of electricity, distribution of gas, TV cables, waste disposal, tourism, banking, etc. and have in some cases a private partner. They often have a legal monopoly in specific sectors and are exempted from corporate taxes. This creates two different problems. First, the private partner is offered an advantageous market position, and, second, conflicts of interest can arise. Regions have taken steps to separate their transport and sales activities in energy. Discussions have started to cut the number of intercommunales and to rationalise their activities, but no major step has been taken.

24. Three parallel projects have been pursued: (1) administrative simplification, (2) fiscal simplification and fight against fraud, and (3) reform of the federal public administration (Copernicus). The Agency for Administrative Reform was created in 1999 and so far 25 projects have been carried out, mainly targeted at developing e-government and assessing the current regulations. In October 2000, the government appointed a Commissioner for tackling fiscal fraud and simplifying tax procedures. Tax procedures have been simplified and are accessible on line. Similar measures are taken at regional level. Furthermore, a major reform of the federal public administration (Copernicus reform) was on the agenda with reforms objectives in structure, management, recruitment, tools, nominations, and use of e-government. Some measures have been taken but legal problems have postponed part of the reform to spring 2002.

Table 1.4: **Product market indicators for Belgium**

	BELGIUM				EU 15			
	1998	1999	2000	2001	1998	1999	2000	2001
Labour productivity[1]	124.6	120.0	120.2	119.3	100	100	100	100
Relative price levels[2]	99.0	102.0	100.0		100	100	100	
Total trade to GDP ratio (%)[3]	65.2	69.1	77.6	77.2	41.2	41.9	46.7	45.8
FDI share (BLEU)[4]	7.00	41.3	87.0		2.7	5.0	8.9	
Cross-border M&A share[5]	3.9(3.1)	4.5(2.9)	4.3(2.9)		100	100	100	
Single Market Directives[6]	5.2	3.5	2.9	2.3	3.9	3.6	3.0	2.0
Value of tenders in the O.J.[7]	1.9	2.3	2.3		1.8	1.8	2.4	
Sectoral and ad hoc State aids[8]	1.1	1.1			1.0	0.9		
Prices in telecommunications[9]								
- Local	0.49	0.49	0.49	0.54	0.41	0.41	0.41	0.41
- National	1.74	1.74	1.74	0.54	2.16	1.69	1.34	1.15
- Call to USA	6.00	5.95	5.95	1.84	5.07	4.09	3.39	2.65
Market share fixed telecom (%)[10]								
- Local		99.0						
- Long Distance		95.0						
- International		89.0						
Electricity prices[11]								
- Households	11.95	11.77	11.68	11.84	10.57	10.48	10.40	10.33
- Industry users	7.56	7.36	7.61	7.68	6.44	6.32	6.44	6.33
Market share electricity (%)[12]		88.9						
Education expenditure[7]	5.2	5.5			5.0	5.0	5.1	
New S&T graduates[13]			14.0					
R&D expenditure[7]	1.90	1.98			1.87	1.92	1.90	
Internet access at home[14]		12.0	29.2	34.7		12.0	28.4	36.1
Patent applications[15]	140.0	145.1	151.2		129.9	140.9	152.7	

All figures for 2001 are estimates. [1] Per person in PPS, EU15=100; [2] EU15=100, private final consumption; [3] (Exports+Imports)/(2*GDP). EU average for small member states (B, DK, EL, IRL, L, NL, A, P, FIN and S);[4] FDI inflows as a % of GDP; [5] % of EU total (GDP share); [6] % not yet implemented; [7] % of GDP; [8] % of GDP (avg. 96-98&97-99); [9] Price in euro of 10 minute call at 11 am on a weekday, VAT included; [10] Market share of the incumbent; [11] Prices in euro per Kwh; [12] Market share of the largest generator; [13] Per 1000 inhabitants aged 20-29; [14] % of households; [15] Per million inhabitants, EPO.

Source: Commission services.

1.4.3 Capital markets

- **Overall assessment**

25. The Belgian stock market further developed over the last years through the intervention of a growing number of market operators (like pension funds or mutual funds). The creation of complementary group pensions by capitalisation, still to be approved by the Parliament, should further boost demand for equities over the coming years. However, the necessary removal of the requirement for pension funds to invest a minimum percentage in Belgian shares in order to benefit from tax incentives (a regulation impeding free capital movements - the adaptation proposed by the Belgian authorities has still to be examined by the European Commission) may have an impact on amounts invested on the Brussels stock market. The integration of the Brussels, Paris and Amsterdam's stock exchanges into Euronext has continued in 2001 with the migration by the three exchanges to a common trading system and the use of a single central clearer. Further to this merger, the financial supervisory authorities have agreed to co-

ordinate their respective competencies (regarding regulation and supervision of Euronext managed markets as well as supervision of clearing activities).

26. Also in terms of financial supervision, the competencies between the Banking and Finance Commission (BFC) and the National Bank of Belgium NBB are to be reorganised (e.g. bank supervision will be institutionally linked to the NBB).

27. The consolidation process within the Belgian banking sector gained momentum during the second half of the 1990s. This M&A activity took place on a cross-border and cross-sectoral basis. As a result, the degree of concentration and the market share of the five largest institutions has increased sharply over the last six years. The degree of concentration is bound to increase further as the merger between Dexia and Artesia Banking Corporation becomes a reality. In the field of consumer protection, a new law is setting a maximum interest rate for overdraft credits on sight deposits.

28. The Belgian venture capital market, that had grown strongly over the last years, stabilised in 2001, albeit at a level similar to the European average. In line with the Risk Capital Action Plan, a law permitting employee participation in the capital of their enterprises and in profits came into force in 2001.

29. Good progress was made in implementing the 2001 capital market recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendation in the 2001 BEPGs	*Degree of implementation*
➢ Develop further the risk capital market by easing quantitative constraints on institutional investment in equity capital, by establishing a fiscal framework more conducive to investment and entrepreneurship, the latter to be also encouraged by adjusting bankruptcy laws	In progress

30. The requirement for pension funds to invest a minimum percentage in Belgian shares is to be removed. The corporate tax rate is to be reduced (to be compensated by the removal of certain allowances), as well as the specific rate applied for SMEs. Reinvested profits are to be partially tax exempted. Procedures in cases of corporate insolvency are to be adapted in order to limit the negative consequences of bankruptcy.

2. DENMARK

2.1 Macroeconomic context

1. Economic activity slowed down in 2001 compared to the high growth rate registered in 2000. This is due to the fading out of the repair work in 2000 that followed a storm, which hit Denmark, and the continuing effects of adverse economic shocks. In 2001, GDP growth was primarily driven by external demand. Nevertheless, domestic demand is expected to gain strength in 2002 and become the main driving factor behind GDP growth. The private consumption component, which has been subdued in recent years, is expected to pick up, as real disposable income increases. Following a stabilisation period in 2000, unemployment fell slightly through 2001. However, an increase in unemployment is expected in 2002 as a result of the slowing down of the economy. Given that the labour market is tight and some firms have experienced problems in hiring, the economic slowdown is expected to a larger extent to result in lower productivity growth rather than increased unemployment. The tightness of the labour market also resulted in high wage increases. Inflation was relatively high in 2000, but has eased considerably in the last year due to lower contributions from oil and import prices. In 2002 it is expected to remain around 2%.

Table 2.1: **Economic developments in Denmark**[1)]

	1992-97	**1998**	**1999**	**2000**	**2001**
Real GDP	2.4	2.5*	2.3*	3.0*	1.3
Domestic demand	3.1	4.0*	-0.5*	2.6	0.5
Private consumption	2.6	2.3*	0.2*	-0.3*	1.2
GFCF (Investment)	4.5	10.0*	1.0*	10.7*	-2.3
Exports (G&S)	2.6	4.3*	10.8*	11.5*	4.1
Imports (G&S)	4.9	8.9*	3.3*	11.2*	2.5
Inflation[2)]	1.8	1.3	2.1	2.7	2.3
Compensation/employee	3.2	3.8	2.9*	3.9	3.8

Note: For footnotes and sources see Table 1.1 for Belgium.

2.2 Key challenges

2. Whereas Denmark made progress in implementing the recommendations of the 2001 BEPGs, a number of key policy issues require continued attention, in particular labour supply constraints, insufficient competition in some private industries, the efficiency of the public sector and the control of public expenditure.

Key economic policy challenges for Denmark

- Overcoming the persistent labour supply constraints (which in the short term contribute to continued wage pressure).
- Increasing competition in some private industries, and improving the efficiency of the public sector.
- Ensuring adequate control of public expenditure, in particular for local authorities.

3. Although the employment rate is the highest in the EU, a substantial number of persons participate in leave and early retirement schemes. Labour supply has been relatively stagnant in recent years, contributing to continued wage pressure and imposing a constraint on growth potential both in the short and longer run. Despite previous reforms, there is still a clear trend towards shorter working weeks and relatively high withdrawal from the labour market. Given the already high participation rates, the challenge of increasing labour supply to sustain the welfare society is still very demanding.

4. The recent introduction of merger control has occurred smoothly. On average, the time taken to complete a case is shorter than in most other Member States. However, over the years, ample evidence has been furnished to suggest that, across a broad range of industries, e.g. printed media, building materials, construction and retailing, competition is less intense in Denmark compared to other Member States. Insufficient competition, together with high taxes and a high standard of living, contributes to the high price level, 21% above the EU average. Substantial effort has been made to improve the efficiency in the public sector, and at present Denmark has one of the highest rates of public procurement, which is openly advertised. However, public entities remain sole producers in many areas of public services, some of which could readily be subjected to bids from private producers. Moreover, a recent survey on the use of tendering by local authorities, responsible for 2/3 of total public spending, revealed that the share of private providers in this area had stagnated in the last decade.

5. The frequent overshooting of the target for government consumption growth remains a key challenge for the Danish economy. Currently, there are no binding ways for the central government to control the expenditure policies of local government. The new government's policy implies a shift in focus of marginal budget improvements from taxes to expenditure. To be fully effective this initiative will also need to be adopted at local government level.

1.3 Public finances

- **Overall assessment**

6. Denmark has in recent years maintained high surpluses on the public finances. The 2001 update of the convergence programme maintained the commitment to ensure high surpluses on the public finances in the medium term in order to prepare for the impact of an ageing population. To the goal of high surpluses has been added a "tax freeze" in order to put a halt to the upward drift in tax ratios.

7. Good progress was made in implementing the 2001 public finance recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendation in the 2001 BEPGs	*Degree of implementation*
➢ Strictly limit the real increase in government consumption in 2001 to the budgeted rise of 1.9 per cent.	2
➢ Maintain high government surpluses in 2001 and the following years.	2
➢ Hold back real growth in government consumption also in the medium term so that the tax burden can decline up to 2005 in line with the government's projections in the updated convergence programme, without jeopardising the capacity of Danish public finances to cater adequately for the ageing population. In particular, more binding commitments from lower levels of government should be sought, while respecting the autonomy of local governments, in order to achieve this.	Partial

8. Although full budgetary data are not yet available for 2001 it seems likely that growth in real government consumption remained below the 1.9% stated in the budget for 2001. The target of 1.9% is, however, well above the general target of 1% and there is also a risk that the target of 1% growth will be exceeded in 2002.

9. The surplus for 2001 is expected to be around 2% of GDP in line with the government's aim of maintaining high surpluses. In the Commissions Autumn 2001 forecasts[1] for 2002 the surplus is expected to be lowered to 1½% of GDP, partly due to lower taxes paid by enterprises.

10. For 2002 the new budget proposal implies a growth rate of real government consumption of 1.3% according to the 2001 update of the convergence programme. This is an increase of 0.3 percentage point compared to the previous update and therefore not strictly in line with the BEPGs. However, this is offset by an estimated real public consumption growth of 0.7% in 2003, leading to an average growth rate of real public consumption of 1% till 2005 which is in line with the recommendation. With regards to achieving more binding commitment from lower levels of government to reduce the tax burden, no institutional changes have been undertaken yet to ensure stronger coherence in the future.

[1] Based on the old budget proposal for 2002.

Table 2.2: **Trends in public finances in Denmark** [1)]

	1994	1996	1998	1999	2000	2001
Government balance [2)]	-2.4	-1	1.1	3.1	2.5	2.2
- Total revenue	59.1	58.8	58.7*	59.1*	56.4*	54.8
Tax burden [3)]	49.9	49.9	50.2*	51.2*	48.8*	47.5
- Total expenditure	61.6	59.8	57.6*	56*	54*	52.6
Primary current expenditure	52	50.7	49.3*	48.5*	47*	46.3
Interest payments	6.7	6.1	5.3	4.7*	4.2*	3.7
Investment	1.8	2	1.7	1.7*	1.7	1.8
Primary balance [2)]	4.2	5.1	6.5*	7.8*	6.7*	6
Government debt	73.5	65.1	56.2*	52.7*	46.8*	43.2
Cyclically-adjusted balance [4)]	-1.9	-1.1*	0.5*	2.5	1.4*	1.6
Cyclically-adj. primary balance [4)]	4.8	5*	5.8*	7.2	5.6*	5.4

Note: For footnotes and source see Table 1.2 for Belgium.

2.4 Economic reforms

2.4.1 Labour markets

- **Overall assessment**

11. Denmark has the best employment performance among the EU countries, already exceeding all the Lisbon targets for the employment rates in 2010 for the EU as a whole. In 2001, employment continued to grow and the labour market situation remained tight. The unemployment diminished slowly and remains at a relatively low level. However, the share of working-age people dependant on benefits is relatively large.

12. Limited progress was made in implementing the 2001 labour market recommendation.

- **Implementation of the 2001 BEPGs**

Country-specific recommendations in the 2001 BEPGs	*Degree of implementation*
➢ Reduce further the overall fiscal pressure on labour over the coming years, especially through lowering high marginal effective tax rates on low and medium wage earners to make work pay, and thus continue reforms of transfer systems.	No new measures

13. The tax reductions granted within the so-called "Whitsun Package" during the first years of the former government's term in office will, despite increases in local government taxes, lead to a reduction in taxes on labour in 2002. The previous reforms of various early retirement and disability pension schemes continue to reduce inflows to these schemes, thus resulting in a reduction in the projected stock of persons benefiting from such schemes. However, no new concrete measures were taken to address the 2001 BEPGs recommendation.

Table 2.3: **Labour market indicators for Denmark**

	Denmark					EU			USA		
	1990	**1994**	**1999**	**2000**	**2001**	**1994**	**2000**	**2001**	**1994**	**2000**	**2001**
Employment rate (ER) [1)]	74.8	72.3	76.0	76.3	:	59.6	63.2	:	72.0	74.1	:
Female ER [1)]	70.2	66.9	71.1	71.6	:	49.3	54.0	:	65.2	67.9	:
Older workers ER [1)]	54.0	50.8	54.5	55.7	:	35.7	37.7	:	54.4	57.7	:
Employment growth [2)]	-0.7	1.4	1.1	0.7	0.4	-0.1	1.7	1.1	2.3	1.9	-0.1
ER full time equivalent	:	65.6	69.7	69.3	:	54.9	57.9	:	:	:	:
Unemployment rate (UR)	7.7	8.2	5.2	4.7	4.5	11.1	8.2	7.8	6.1	4.0	4.8
Long-term UR [1)]	2.9	2.9	1.2	1.0	:	5.2	3.6	:	:	:	:
Youth UR (<25)	11.4	11.0	9.6	7.3	6.7	22.1	16.2	15.5	12.4	9.3	10.6
Nominal wage growth [2)]	4.0	1.5	4.0	3.9	3.8	3.1	3.0	3.3	2.4	5.1	5.3
Real Unit Labour Cost growth [2)]	-1.3	-4.1	-0.1	-2.2	-0.1	-2.4	-0.1	0.3	-1.1	0.7	1.8
Labour Productivity growth [2)]	1.7	4.0	1.0	2.5	0.9	2.9	1.6	0.5	1.5	2.1	1.0
Tax rate on average wage earners [3)]	:	45.2	44.6	44.4	44.2	44.6	43.6	43.0	31.2	30.8	30.0
Tax rate on low wage earners[3)]	:	:	41.3	41.2	41.1	:	38.6	37.8	:	29.0	27.7
NRR on low income families (married) [4)]	:	77.0	77.0	:	:	72.0	67.0	:	59.0	59.0	:
NRR on low wage earners (single) [4)]	:	90.0	89.0	:	:	71.0	68.0	:	59.0	59.0	:

Note: For footnotes and sources see Table 1.3 for Belgium.

2.4.2 Product markets and the knowledge-based economy

- **Overall assessment**

14. The Danish economy is less open (as measured by the total trade-to-GDP ratio) than most other small Member States and the relative price levels are high, partly because of the lack of competition in a number of industries. Although the share of advertised public procurement is high compared to the rest of the EU and is rising, public tendering at the local level is low and stagnates at around 10%. Denmark is also the second best performer in the EU in the field of the transposition of internal market directives and sectoral and ad hoc States aids are low. Significant progress have been made in liberalising telecoms and energy sectors, which has contributed to lower prices.

15. Of all Member States, Denmark has the highest spending ratio on education as well as the greatest proportion of people with at least upper secondary education. However, spending on R&D, and the resulting patenting activity, continue to trail those of its frontrunner neighbours, Sweden and Finland. Denmark compares more favourably with respect to ICT. The early liberalisation of telecom markets, and a generally tech-savvy population have produced an Internet penetration almost double the EU-average, and one of the highest rates of broadband connections.

16. Some progress was made in implementing the 2001 product market recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendations in the 2001 BEPGs	*Degree of implementation*
➢ Strengthen enforcement of competition rules in those industries where competition has been found to be inadequate.	Partial
➢ Enhance conditions for competition in public procurement, and heighten competitive pressures in public services provision at the local level through benchmarking and increased use of public tendering.	In progress

17. The Competition Authority continues to highlight areas where competition seems to be hampered, but no further concrete action has been taken toward strengthening competition in industries, where it has been found to be insufficient. However, a further tightening of competition law is being considered, which would make the investigation of cartels easier and, at same time, raise penalties from what is currently a very low level by international standards. Some specific measures have been introduced in the construction sector, removing restrictions on electronic tendering as well as on the number of tenders a private constructor is allowed to solicit.

18. The share of advertised public procurement has increased. The central government regularly benchmarks public services. Among others, the Foreign Service, the Police, and the municipal court system have come under scrutiny in the past two years, and benchmarking is spreading at the municipal level too. One drawback is the absence of a general requirement to undertake benchmarking. The extent to which public services are subject to tenders varies a great deal across local authorities. For central government services, the volume of tendering has increased only slightly in recent years. Based on a survey of local authorities, the Competition Authority has formulated a series of recommendations on how to expand the use of tendering as a means to increase efficiency in the provision of public services.

Table 2.4: **Product market indicators for Denmark**

	DENMARK				EU 15			
	1998	1999	2000	2001	1998	1999	2000	2001
Labour productivity[1]	99.74	101.7	104.1	104.7	100	100	100	100
Relative price levels[2]	124.0	122.0	121.0		100	100	100	
Total trade to GDP ratio (%)[3]	27.4	27.2	29.7	29.2	41.2	41.9	46.7	45.8
FDI share[4]	3.7	6.5	9.7		2.7	5.0	8.9	
Cross-border M&A share[5]	2.7(2.1)	3.2(2.0)	3.3(2.1)		100	100	100	
Single Market Directives[6]	1.5	1.3	1.1	0.8	3.9	3.6	3.0	2.0
Value of tenders in the O.J.[7]	2.2	2.4	3.5		1.8	1.8	2.4	
Sectoral and ad hoc State aids[8]	0.5	0.5			1.0	0.9		
Prices in telecommunications[9]								
- Local	0.45	0.41	0.41	0.41	0.41	0.41	0.41	0.41
- National	0.66	0.63	0.54	0.41	2.16	1.69	1.34	1.15
- Call to USA	5.25	4.72	4.72	2.72	5.07	4.09	3.39	2.65
Market share fixed telecom (%)[10]								
- Local			74.0					
- Long Distance			74.0					
- International								
Electricity prices[11]								
- Households	6.70	6.76	7.15	8.13	10.57	10.48	10.40	10.33
- Industry users	4.97	4.71	7.96	5.64	6.44	6.32	6.44	6.33
Market share electricity (%)[12]		26.0						
Education expenditure[7]	8.2	8.0			5.0	5.0	5.1	
New S&T graduates[13]	8.1							
R&D expenditure[7]	2.02	2.00			1.87	1.92	1.90	
Internet access at home[14]		35.0	51.6	58.9		12.0	28.4	36.1
Patent applications[15]	139.7	168.5	169.5		129.9	140.9	152.7	

Note: For footnotes and source see Table 1.4 for Belgium.

2.4.3 Capital markets

- **Overall assessment**

19. The Danish financial sector has been characterised by extensive restructuring activity and increased integration. Danish holdings of shares in foreign companies have grown substantially as a percentage of total shareholdings. 2001 saw also the creation of a Pan-nordic financial conglomerate (Nordea). To ensure efficient supervision of these cross-sector cross-border groups, the financial supervisory authorities of the Nordic countries signed a collaboration agreement in October 2000.

20. Several measures were taken to increase transparency (e.g.: publication of key indicators for the soundness of individual financial companies, proposal to establish a Danish insider register, changes in the Copenhagen Stock Exchange reporting rules). Financial legislation was simplified by the consolidation in one single act all those rules that are common to different types of financial institutions. The practice whereby financial companies are required by law to admit one government appointee as member of the board of directors is to be discontinued.

21. Measures were taken to support the development of pension funds. A committee is to examine the possibilities of increasing customer choice relating to the investment as well as the management of pension savings and to facilitate moving from one institution to another. New tax rules on pension funds have been introduced to restore symmetry in the way gains and losses are treated for tax purposes. Some quantitative constraints on equity investment have been removed or made more flexible (by making them conditional on the financial health of each fund individually).

22. Recent analyses have produced evidence to suggest that the volume of the Danish venture capital market may be underestimated. Notwithstanding these findings, the venture capital market can be further developed - especially in early-stage funding. Parliament agreed in 2001 to grant the publicly-funded Growth Fund greater flexibility to design financial instruments aimed at stimulating the supply of risk capital. In parallel, the Fund received additional funding to set up a loan guarantee system.

23. Some progress was made in implementing the 2001 capital market recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendation in the 2001 BEPGs	*Degree of implementation*
➢ Develop the risk capital market by further adapting the fiscal framework so as to facilitate investment and entrepreneurship, the latter to be also encouraged by adjusting bankruptcy laws	In progress

24. The budget bill for 2002 contains a package of measures to enhance innovation, restructuring and competitiveness. The measures include a deferral of taxation of employee stocks and stock-options until realisation; wider access to tax favoured savings for business entrepreneurs; lighter taxation of succession and removal of the 5 year limit for carrying forward deficits. Also earlier measures imply that tax credits are to be granted in connection with investments in small and innovative businesses through the establishment of innovation funds. Costs relating to asset management are to be deductible for tax purposes. Measures for a fairer and simpler taxation on capital gains are under consideration. There have been no changes to the laws on bankruptcy, but a working group has been formed. The remit of this group includes making recommendations regarding the rules on debt rescheduling and the restructuring of insolvent firms.

3. GERMANY

3.1 Macroeconomic context

1. Last year brought an abrupt end to the economic expansion of 2000, which registered a growth rate of 3%. Indeed, the very modest 0.6% growth rate attained in 2001 is nearly exclusively due to a positive statistical overhang. In spite of a noticeable tax reduction in January 2001, the German economy has stagnated or shrunk since the second quarter of last year. Underlying reasons for the slowdown are the loss in purchasing power due to the 1999/2000 oil price hike, and the worsening international environment, which took its toll on economic confidence. As a result, private consumption remained weak and investment declined, especially in the construction sector. Average HICP inflation in 2001 was 2.4%; after a peak rate of 3.5% in May, it fell to 1.7% in December. The expected recovery after spring of 2002 will bring some reprieve. However, with an expected growth rate of some ¾% for 2002, Germany will again be lagging behind other economies in the EU. The slowdown has started to lead to rising unemployment, which is likely to be around the 4 million threshold in 2002. This development threatens to undo much of the considerable employment gains of the last few years and to bring Germany's budgetary position close to the Treaty's 3% reference value.

Table 3.1: **Economic developments in Germany**[1)]

	1992-97	1998	1999	2000	2001
Real GDP	1.2	2.0	1.8	3.0	0.6*
Domestic demand	1.1	2.4	2.6	2.0	-0.5*
Private consumption	1.2	1.8	3.1	1.5	1.4*
GFCF (Investment)	0.5	3.0	4.2	2.3	-4.1*
Exports (G&S)	3.7	6.8	5.6	13.2	5.1*
Imports (G&S)	3.3	8.9	8.5	10.0	2.0
Inflation[2)]	:	0.6	0.6	2.1	2.4
Compensation/employee	3.8	1.0	1.2	1.2	1.6*

Note: For footnotes and sources see Table 1.1 for Belgium.

3.2 Key challenges

2. Whereas Germany made progress in implementing the recommendations of the 2001 BEPGs, a number of key policy issues require continued attention, in particular the consolidation of public finances, the high unemployment rate and regional unemployment disparities, the employment rate and the business environment.

Key economic policy challenges for Germany

- Accelerating the consolidation of public finances and ensuring a strict implementation of the stability programme, in particular with a view to keeping the government deficit in 2002 below the Treaty's 3% of the GDP reference value.
- Reducing the persistent high unemployment rate and regional unemployment disparities, and increasing the efficiency of active labour market policies.
- Increasing the employment rate, reforming the benefit schemes to make work pay and tackling disincentives to labour market activity, especially for women.
- Improving the business environment, particularly by reducing regulation of product and labour markets.

3. In 2001, Germany saw a clear deterioration in its nominal budget deficit compared to 2000, when the deficit reached 1.3% of GDP (excluding one-off UMTS receipts). In 2001 the budget deficit rose to 2.6% of GDP, mainly due to the strong slowdown in growth, from 3.0% in 2000 to 0.6% in 2001. Modest growth projections for 2002 – below 1%– point to the risk that the deficit in 2002 may even come closer to the Treaty's reference value. Furthermore, the unfavourable developments in 2001 and 2002 put the medium-term targets at risk. Should Germany have to face the age-related problems, especially of the pension and health systems, from a weak budgetary position, an undesirable rise in contribution rates would be difficult to avoid.

4. Unemployment remains stubbornly high and continues to have a strong regional dimension. While the positive employment development in 2000 was confined to the West, the job losses in 2001 also mainly concern the western Länder. Still, regional unemployment varies between 5.2% in *Baden-Württemberg* and 19.1% in *Sachsen-Anhalt* (Dec. 2001, national definition). Although wage formation has become *de facto* somewhat more flexible, wage differentiation is still too low to contribute significantly to bringing regional labour markets into equilibrium, and mobility remains rather low. As evaluations show, large-scale ALMPs in high-unemployment regions clearly appear to lack efficiency.

5. Disincentives with respect to labour market activity remain a major obstacle to higher employment. While the stepwise realisation of the tax reform has led to a reduced tax burden, in particular on low-wage earners, high social security contributions and the withdrawal of benefits may discourage low skilled workers, in particular, from taking up a job or working longer hours. The labour market activity of low-skilled workers is very low and their unemployment risk is 60% higher than that of the average worker. Unemployment and poverty traps also seem to be an impediment for secondary earners. While the female employment rate is above the intermediate target agreed upon in Stockholm, the lack of childcare facilities leaves many women with the choice of either interrupting their career or not having children.

6. Despite efforts to reduce the regulatory burden on business, the economy is still characterised by a high degree of regulation in product and labour markets. The Federal government, in particular, has taken various measures to improve the framework conditions within which business has to operate (e.g. the *'Mittelstand'* and *'Modern State - Modern Administration'* action programmes, tax reform). However, according to a recent survey covering all Member States, German companies are the least satisfied

with the quality of their regulatory environment. Labour market regulation continues to be relatively strict, and effective corporate tax rates remain amongst the highest in the EU.

3.3 Public finances

- **Overall assessment**

7. The first deficit estimate for 2001 published by the Federal Statistical Office on 17 January 2002 shows an overall government deficit of 2.6% of GDP. While most of the deterioration was due to the slowdown in growth and part to a statistical revision of past figures, expenditure overruns occurred at other levels of government, especially in the health care system. The new update of the German stability programme projects a deficit of 2½% for 2002, based on a growth forecast of ¾%. According to Commission forecasts, even this projection is subject to risks (notably the potential revision to 2001 outcome, shortfalls in tax revenues and overshooting of expenditure targets).

8. Some progress was made in implementing the 2001 public finance recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendations in the 2001 BEPGs	*Degree of implementation*
➢ Attain a general government deficit of 1½ per cent of GDP in 2001; to this end, growth of government expenditure in 2001 should respect projections set in the framework of the November 2000 Finanzplanungsrat;	Partial
➢ When preparing the budget for 2002, maintain the planned reduction in the general government deficit to 1 per cent of GDP, even if economic growth in 2001-02 should turn out lower than projected in the updated stability programme of October 2000, so as to ensure that the medium-term target of a balanced budget by 2004 can be met; in the event of higher than projected tax revenues these should be used to reduce the deficit below the targeted level.	No new measures
➢ Reinforce from 2001 onwards the co-ordination of budgetary policy among the various levels of government by strengthening the role of the 'Finanzplanungsrat' and, eventually, in the framework of a national stability pact.	In progress
➢ In order to secure the longer-term sustainability of government finances continue the implementation of the pension reforms and start in 2001 the elaboration of reforms of the health care sector and dependency insurance, particularly of long-term care for the elderly.	Partial

9. According to the first estimate by the Federal Statistical Office, the 2001 general government deficit reached 2.6% of GDP compared to a projection of 1½% in the October 2000 update of the German stability programme. While overall expenditure remained close to targets, there were overruns at the level of health care systems and in some Länder.

10. The new update projects a 2002 general government deficit of 2½% of GDP, based on an assumption of GDP growth of ¾%. While expenditure in social security systems is projected to rise by 2½% compared to last year, the different levels of government are projected to increase expenditure by 1½% only.

11. As shown once more by events in 2001, the attainment of agreed deficit targets is highly dependent on all levels of government respecting the mutually agreed expenditure growth rates of the Finanzplanungsrat. While the recently agreed changes to the Haushaltsgrundsätzegesetz constitute a progress, there is no sanction mechanism comparable to the one enshrined in the Stability and Growth Pact or to the ones agreed by other federally organised EU member states.

12. In the health care sector, the budget ceiling on the consumption of pharmaceuticals was lifted at the beginning of 2001. This induced a strong rise in the consumption of pharmaceuticals, explaining an important part of the sector's deficit in 2001. Given which deficit, the different health care systems were obliged to raise contribution rates, a policy going counter not only against the federal government's declared target but also the previous Council opinions on the updated stability programmes. The first step of pension reform was implemented as planned.

Table 3.2: **Trends in public finances in Germany** [1)]

	1994	**1996**	**1998**	**1999**	**2000**	**2001**
Government balance [2)]	-2.4	-3.4	-2.2	-1.6	1.2	-2.6*
- Total revenue	46.5	46.8	46.6	47.4	47.1	-45.8*
Tax burden [3)]	41.4	42.1	42.1	42.9	43.0	41.8
- Total expenditure	49.0	50.3	48.8	48.9	45.9	48.4*
Primary current expenditure	40.9	42.5	41.4	41.5	41.2	41.5
Interest payments	3.3	3.7	3.6	3.5	3.4	3.2*
Investment	2.7	2.1	1.9	1.9	1.9	1.8*
Primary balance [2)]	0.9	0.3	1.4	2.0	4.5	0.6*
Government debt	49.4	59.8	60.9	61.3	60.3	60.5
Cyclically-adjusted balance [4)]	-2.8	-3.2	-1.9	-1.3	-1.6	-2.3
Cyclically-adj. primary balance [4)]	0.5	0.5	1.7	2.3	1.7	0.9

Note: For footnotes and source see Table 1.2 for Belgium.

3.4 Economic reforms

3.4.1 Labour markets

- **Overall assessment**

13. In 2000, the employment rate in Germany was above the EU average and Germany registered the strongest employment growth since reunification, but following the economic downturn, a similar performance could not be achieved in 2001. While youth unemployment is significantly below the EU average, long-term unemployment

accounts for half of the total unemployment, the east-western labour market divide is still strong, and unemployment remains particularly high among low-skilled workers.

14. Some progress was made in implementing the 2001 labour market recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendations in the 2001 BEPGs	*Degree of implementation*
➢ Target ALMPs better towards those groups most prone to the risk of long-term unemployment and ensure that training better matches the demands of the labour market. Improve the efficiency of ALMPs, in particular in the New Länder. Continue to encourage the wage formation process to better take into account productivity and regional labour market conditions.	Partial
➢ Complement the income tax reform with further reforms of the tax and benefit system to make work pay. Further steps should be taken to reduce the still-high level of non-wage labour costs, in particular for low wage labour.	Partial
➢ Take measures, where appropriate in the framework of the "Alliance for Jobs", to make work contracts and work organisation more flexible and to improve the conditions for life-long learning.	Partial

15. Globally, the "Job AQTIV" bill is a step in the right direction. Experience in other Member States suggests that job-search assistance and stricter application of benefit sanctions can influence unemployment positively. Profiling is a precondition for better targeting of ALMPs, but so far the unsatisfactory efficiency of large-scale ALMPs, in particular in eastern Germany, is not addressed and current plans for better evaluation seem to lack ambition. Moreover, using subsidised work for public investment in infrastructure carries the risk of exacerbating dead-weight losses. Despite some progress, more needs to be done to adapt wage increases to the need to achieve wage structures that better reflect productivity differences; the ongoing trend towards informal decentralisation of wage bargaining should be carefully monitored and assessed.

16. Social security contributions have recently come under new upward pressure. It is now planned to introduce the subsidies to low-wage earners' social security contributions that are currently being tested in pilot projects on a nation-wide scale. The "stick and carrot" approach, consisting of a stronger enforcement of job search requirements combined with job search assistance, will improve incentives to work, if properly implemented. Still, no comprehensive plans (covering eligibility for benefits as well as their duration, and rules governing the withdrawal of benefits) to address the disincentives arising from benefit schemes have so far been put forward.

Table 3.3: **Labour market indicators for Germany**

	Germany					EU			USA		
	1990	**1994**	**1999**	**2000**	**2001**	**1994**	**2000**	**2001**	**1994**	**2000**	**2001**
Employment rate (ER) 1)	:	64.7	64.8	65.3	:	59.6	63.2	:	72.0	74.1	:
Female ER 1)	:	55.1	57.1	57.8	:	49.3	54.0	:	65.2	67.9	:
Older workers ER 1)	:	36.6	37.7	37.3	:	35.7	37.7	:	54.4	57.7	:
Employment growth 2)	3.0	-0.2	1.1	1.5	0.0	-0.1	1.7	1.1	2.3	1.9	-0.1
ER full time equivalent	:	59.8	58.3	58.6	:	54.9	57.9	:	:	:	:
Unemployment rate (UR)	4.8	8.4	8.6	7.9	7.9	11.1	8.2	7.8	6.1	4.0	4.8
Long-term UR 1)	:	3.8	4.4	3.9	:	5.2	3.6	:	:	:	:
Youth UR (<25)	4.5	8.8	9.1	9.1	9.4	22.1	16.2	15.5	12.4	9.3	10.6
Nominal wage growth 2)	4.7	3.0	1.4	1.2	2.0	3.1	3.0	3.3	2.4	5.1	5.3
Real Unit Labour Cost growth 2)	-1.1	-2.0	0.1	0.2	0.0	-2.4	-0.1	0.3	-1.1	0.7	1.8
Labour Productivity growth 2)	2.7	2.5	0.8	1.4	0.6	2.9	1.6	0.5	1.5	2.1	1.0
Tax rate on average wage earners 3)	:	48.3	51.9	51.9	50.7	44.6	43.6	43.0	31.2	30.8	30.0
Tax rate on low wage earners 3)	:	:	47.0	46.5	45.4	:	38.6	37.8	:	29.0	27.7
NRR on low income families (married) 4)	:	80.0	70.0	:	:	72.0	67.0	:	59.0	59.0	:
NRR on low wage earners (single) 4)	:	73.0	67.0	:	:	71.0	68.0	:	59.0	59.0	:

Note: For footnotes and sources see Table 1.3 for Belgium.

17. A recent IAB study suggests that the increased use of working time accounts enhances the firms' capacity to deal with short-term variations in their demand situation and may stabilise employment. On the other hand, EPL seems to be a factor contributing to the structural rigidities of the labour market. Care should be taken that the reform of works councils does not reduce labour market flexibility. Job rotation and a recent refocusing of ALMPs have been designed to improve older workers' labour market prospects. It is, however, still too early to assess the impact of these measures.

3.4.2 Product markets and the knowledge-based economy

- **Overall assessment**

18. The German economy is relatively open (as measured by the total trade-to-GDP ratio). However, the stock of German direct investment abroad exceeds the stock of foreign direct investment in Germany by 80%. Progress on Internal-Market related issues (transposition of Single Market Directives, opening up of public procurement) has been limited, but sectoral and ad hoc State aids have continued their gradual decline. Liberalisation has contributed to lower telecom and electricity prices, but price levels for electricity (households) and gas remain well above the EU average and, *de facto*, regional suppliers continue to operate as monopolists in distribution. Time and cost requirements for the start-up of a private limited company are around the EU average and only minimal for sole traders.

19. Germany continues to build on its relatively strong position in the knowledge-based economy. Business expenditures on R&D and the number of patent applications

registered with the EPO have been rising, while the share of the labour force with at least upper secondary education is the highest amongst EU Member States. Internet access at home and in the work place are now above the EU average, and since October 2001 all schools are provided with internet access. However, the use of government services on line is below average. It is not clear that the current advances in the transition to the knowledge-based economy will be sustainable in the longer run, as public expenditures on education as a percentage of GDP, the educational achievements of 15-year-olds, the share of high school students that go on to university, and the output of new science and engineering graduates are all below the EU average.

20. Good progress was made in implementing the 2001 product market recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendations in the 2001 BEPGs	*Degree of implementation*
➢ Reform the higher education system and reduce shortages of IT personnel through education and training.	2
➢ Reinforce competition in product markets by further opening-up of public procurement, continuing the policy of gradual reductions in State aid, and continuing to decrease the regulations for the professions and handicraft trade.	In progress
➢ Make efforts to reduce the large regional differences in the fees for the use of local electricity distribution networks.	Partial

21. The reform of the higher education system, which became effective on 1 January 2002, implies the introduction of a performance-linked pay scale for professors, the creation of positions for so-called ‘junior professors’, the allocation of public finances between universities based on their performance in research and education, the increased use of modern management tools, and the delivery of internationally comparable degrees. A number of measures have been taken to reduce shortages of IT personnel, including a rise in the number of vocational training places, improvements in continuous education and the modernisation of the educational programme at the university level. As a result of these measures, 100,000 additional IT experts had been mobilised by the end of 2000.

22. On 1 February 2001, a new regulation entered into force implying the transposition of all Community directives on public procurement. This new regulation includes a provision for a 14-day waiting period between the date of selection of the best tender and the date at which the contract is awarded, allowing time for appeal by those whose offer was not selected. Moreover, it permits the delivery of electronic tenders. Nevertheless, there is no evidence of a significant rise in the value of German tenders published in the Official Journal. The Federal government is continuing its policy of gradual reductions in State aid, adding up to a 32% decline over the period 1999-2005. Entry into the handicraft trades, for both Germans and other EU citizens, was facilitated by the so-called ‘Leipziger Beschlüsse’ of 21 November 2000, which recommended a uniform and broad application of exceptions to the ‘Meisterprüfing’ requirement. In addition, a change in legislation is under preparation, which should facilitate the cross-border delivery of handicrafts. Finally, some legal constraints on the professions have been lifted.

23. The fees charged for the use of the local electricity distribution networks continue to differ significantly between regions and are generally higher than in most other Member States. In reaction, a scheme for comparing such access fees has recently been adopted and the German competition authorities are currently carrying out numerous investigations whether such fees are justified. A test case against a large network operator led to a decline in grid-use fees. In order to handle the increased case load, a new department was created within the federal competition authority and additional resources were made available. Also, new procedural rules (immediate enforcement of decisions as a rule, reversal of the burden of proof) are being discussed in order to ensure effective competition in the electricity market.

Table 3.4: **Product market indicators for Germany**

	GERMANY				EU 15			
	1998	1999	2000	2001	1998	1999	2000	2001
Labour productivity[1]	98.3	98.6	97.8	97.5	100	100	100	100
Relative price levels[2]	106.0	104.0	102.0		100	100	100	
Total trade to GDP ratio (%)[3]	23.6	24.1	28.1	28.6	21.7	21.8	24.8	24.7
FDI share[4]	1.2	3.0	9.7		2.7	5.0	8.9	
Cross-border M&A share[5]	15(27.1)	16(25.1)	15(23.8)		100	100	100	
Single Market Directives[6]	2.7	2.9	3.1	2.6	3.9	3.6	3.0	2.0
Value of tenders in the O.J.[7]	1.1	0.9	1.0		1.8	1.8	2.4	
Sectoral and ad hoc State aids[8]	1.2	1.0			1.0	0.9		
Prices in telecommunications[9]								
- Local	0.44	0.43	0.43	0.43	0.41	0.41	0.41	0.41
- National	2.93	1.86	1.24	1.23	2.16	1.69	1.34	1.15
- Call to USA	4.32	2.45	2.45	1.23	5.07	4.09	3.39	2.65
Market share fixed telecom (%)[10]								
- Local			70.0					
- Long Distance			70.0					
- International			61.0					
Electricity prices[11]								
- Households	12.57	12.93	11.99	12.26	10.57	10.48	10.40	10.33
- Industry users	8.24	7.93	6.72	6.83	6.44	6.32	6.44	6.33
Market share electricity (%)[12]		28.1						
Education expenditure[7]	4.7	4.7			5.0	5.0	5.1	
New S&T graduates[13]	8.8	8.6						
R&D expenditure[7]	2.31	2.43	2.45		1.87	1.92	1.90	
Internet access at home[14]		11.0	27.1	37.9		12.0	28.4	36.1
Patent applications[15]	247.6	273.5	296.8		129.9	140.9	152.7	

Note: For footnotes and source see table 1.4 for Belgium.

3.4.3 Capital markets

- **Overall assessment**

24. After a dynamic evolution in previous years, the world decline in equity prices in 2001 was reflected in a decline in equity financing in Germany. The pace of equity issuance slowed in the first two quarters of 2001, before recovering moderately from the third quarter onward. The availability of equity capital for young high-tech companies was

particularly affected, as the German “Neuer Markt” went through a severe consolidation process. Deutsche Börse has reacted by modernising the legal framework of the "Neuer Markt" segment (imposing more severe reporting rules and excluding low value shares) in order to restore investor confidence in the new market segment. Due to the more difficult business environment, the pressure for consolidation in the German banking sector has increased significantly. So far, a merger involving the major commercial banks' mortgage subsidiaries has taken place.

25. In the field of capital market reforms, the draft on the 4th Financial Market Promotion Act was adopted by the cabinet in November 2001. Its entry into force is scheduled for May 2002. This Act will improve security for investors by stronger controls on price manipulation and insider trading and give exchanges and capital investment companies more flexibility to run their business. Moreover, the law is part of a comprehensive strategy to enhance the competitiveness of German financial markets. A law enhancing transparency of public security offers and take-over procedures came into force in January 2002. Together with the company tax reform, this could give incentives to reduce the widespread cross-ownership of German companies, and is likely to increase capital market efficiency by an enhanced pressure for shareholder value. A comprehensive report on Corporate Governance was published in July 2001 and a commission was asked to prepare a Corporate-Governance-Codex by spring 2002. The law integrating the supervision of the German banking, insurance and securities sector by the creation of a new federal agency has been adopted by the Cabinet in August 2001 and is due to become effective in April 2002. Capital market reforms are supplemented by a draft law for restructuring of the Bundesbank, adjusting its organisational structure to the assignments under the Euro-system.

26. Germany has pursued efforts to provide more capital to young enterprises. The equity capital programme on participation capital (BTU "Beteiligungskapital”) for small high-tech companies will be continued and extended to enterprises which have not been able to negotiate with venture capital companies yet. The reform of the pension system, passed in May 2001, foresees the creation of pension fund arrangements that should also stimulate venture capital markets. The tax authorities of the federal government and the Länder have worked out the draft of an administration directive for the taxation of Venture Capital Funds and Private Equity Funds. It aims at a coherent regulation at federal level to avoid different taxation of equal matters by the tax authorities of the various Länder.

27. Some progress was made in implementing the 2001 capital market recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendation in the 2001 BEPGs	*Degree of implementation*
➢ Further develop the risk capital market by continuing efforts to establish a fiscal and regulatory framework more conductive to investment and entrepreneurship.	In progress

28. The creation of pension funds and restructuring incentives provided by the reform of the taxation of holding transfers will probably strengthen not only the stock market but also help to develop further the German risk capital market. The harmonisation of the taxation of venture capital funds will increase investor's certainty about their legal position and thus their planning decisions.

4. GREECE

4.1 Macroeconomic context

1. In 2001, the economy was influenced by adverse economic shocks. Exports, particularly buoyant in 2000, decelerated significantly in 2001 and as a result real GDP growth slowed down remaining, nevertheless, above 4%. This same pattern is expected for 2002, with GDP growth likely to remain above 3%. The main source of growth is domestic demand, driven by investment in the context of the preparation of the Olympic games of 2004 and sustained by considerable financial assistance of EU Structural Funds, while the current negative contribution of the external balance is not expected to be reversed in the medium-term. Since 2001, employment has responded positively to the current expansion phase, contributing to the progressive improvement of the situation in the labour market and the fall in the unemployment rate. Total employment is estimated to have increased by around 1% in 2001, while the unemployment rate fell although still exceeding 10% of the labour force. Inflation accelerated further until summer 2001 due to second round effects of surging oil prices in 2000, averaging 3.6% for the whole year.

Table 4.1: **Economic developments in Greece**[1)]

	1992-97	**1998**	**1999**	**2000**	**2001**
Real GDP	1.5	3.1	3.4	4.3	4.1
Domestic demand	1.8	4.6	3.0	4.4	4.2
Private consumption	1.9	3.1*	2.9*	3.2*	3.1*
GFCF (Investment)	1.7	11.8	7.3	7.8	9.1
Exports (G&S)	5.8	5.9	6.5	18.9	5.7
Imports (G&S)	5.4	11.3	3.9	15.0	5.6
Inflation [2)]	:	4.5	2.1	2.9	3.6
Compensation/employee	11.3	6.0	4.8	6.1	5.5

Note: For footnotes and sources see Table 1.1 for Belgium.

4.2 Key challenges

2. Whereas Greece made progress in implementing the recommendations of the 2001 BEPGs, a number of key policy issues require continued attention, in particular the sustainability of public finances, the low level of productivity and the high rate of structural unemployment.

Key economic policy challenges for Greece

- Improving the sustainability of public finances, in particular in view of the still high debt ratio; reforming the pension system to address the challenges resulting from the ageing population.
- Increasing the low level of productivity, which is associated with the functioning of the labour and product markets, low investment in human capital, the still difficult business environment, including corporate taxation, and the late development of the knowledge based society.
- Tackling the high rate of structural unemployment, and increasing employment rates, particularly for women.

3. Despite the considerable progress made in recent years the debt-to-GDP ratio remained high, at around 100% in 2001. This requires continued budgetary adjustment in order to address, in particular, future challenges associated with the budgetary costs of the ageing population. In this context, Greece needs to proceed to the reform of the pension system and of the overall social security sector. The issue, already raised as a first priority in the 2000 stability programme of Greece, was planned to start already in 2001, but no progress has been made so far. The 2001 update of the stability programme covering the period until 2004 still recognises the need for reform but no specific plan or timetable is presented.

4. In spite of its increasing path, labour productivity in Greece is the second lowest in the EU. This may be partly explained by the low availability of skilled human capital and the relatively slow pace of product market reforms and the late transition to the knowledge-based economy. While efforts are underway to improve the business administrative environment, this has still to be translated into a comprehensive process of regulatory quality improvement, and companies remain broadly dissatisfied with their country's regulation and the efficiency of the public administration. An overall tax reform is pursued to simplify and increase the transparency of corporate taxation, which is relatively complex and thought to discourage firms' growth. The low levels of education attainment of the population remain a concern, and are among the factors responsible for the overall still low –albeit growing– level of ICT diffusion in Greece and particularly the very weak R&D and innovation performance.

5. A further key challenge is to tackle the high level of structural unemployment and to increase the employment rate. The unemployment rate is among the highest in the EU, and employment rates are low, particularly for women. Moreover, the labour market displays a high degree of segmentation, with very high rates of long-term, female and youth unemployment. Half of all job-seekers lack previous work experience. The strong degree of labour market segmentation seems to reflect a lack of flexibility in the labour market, including a relatively high minimum wage, insufficient wage differentiation and strict employment protection legislation, as well as inadequacies in the educational system.

4.3 Public finances

- **Overall assessment**

6. Budgetary adjustment has been pursued with consistency for a number of years, within the framework of convergence programmes and the first stability programme presented in December 2000. In 2001 the general government accounts were in balance after having recorded a deficit of 1.1% of GDP in 2000. The fiscal consolidation strategy has been based on high primary surpluses, which reached 6.1% of GDP in 2000 and around 6.5% in 2001; the government debt ratio is estimated to have been reduced by almost 3 percentage points to 99.8% of GDP in 2001.

7. The first update of the Greek stability programme, covering the period 2000-2004, is projecting a general government surplus of 0.8% in 2002 which would rise to 1.2% of GDP in 2004; according to the programme, the government debt ratio might decline to 90% in 2004.

8. Some progress was made in implementing the 2001 public finance recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendations in the 2001 BEPGs	*Degree of implementation*
➢ Ensure that the budgetary target of a surplus of 0.5% of GDP set for 2001 is met and be ready to tighten the budgetary implementation in 2001 should inflationary pressures persist.	Partial
➢ Maintain in the budget for 2002 a budgetary stance clearly oriented towards price stability; to this end, respect the government primary surplus objective of 7% of GDP mainly through fast retrenchment in government current primary expenditure applying clear and binding norms.	Partial
➢ Pursue the reform of the public sector in order to reduce its size in the medium-term with a view to improving the competitiveness of the economy and to alleviating the burden on public finances.	In progress
➢ Accelerate the implementation of the reform of the social security sector in order to ensure the viability of the system; in particular, initiate in 2001 the reform of the pension system needed to address the challenges resulting from the ageing population	No new measures

-

9. Based on a macroeconomic scenario of high real GDP growth reaching 5% in 2001, the first stability programme of Greece presented in 2000, was targeting a surplus of 0.5% of GDP for the general government. Due to a shortfall in budget revenues following the lower-than-assumed GDP growth and to an overrun in primary expenditure, mostly wages and transfers, the target was not met but still the general government was in balance in 2001. However, without one-off proceeds from the allocation of mobile phone licences (UMTS) equal to GRD 170 bn, the general government balance would be in deficit of around 0.4% of GDP.

10. In a context of lower GDP growth than assumed in the first stability programme, the budget for 2002 targets a surplus of 0.8% of GDP for the general government and a primary surplus of 6.4% of GDP. However, no clear binding norm was set for current primary expenditure, which is projected to hardly decline in 2002.

11. Privatisation in the form of flotation of public companies shares in the Athens Stock Exchange continued through 2001, albeit at a slower pace than in previous years, partly due to unfavourable conditions prevailing in the stock market. Despite some progress made, the issue of reducing the budgetary burden of the still large public sector and of improving the efficiency of the public sector remains a first priority of economic policy.

12. Finally, the reform of the social security sector with a view to address future challenges associated with the ageing population, was set back after an unsuccessful attempt in the first half of 2001.

Table 4.2: **Trends in public finances in Greece [1)]**

	1994	**1996**	**1998**	**1999**	**2000**	**2001**
Government balance [2)]		-7.8	-3.1	-1.8	-1.1	0.0
- Total revenue		38.1	41.5	46.6	47.7	47.8
Tax burden [3)]		33.0	36.4	37.4	38.1	37.3
- Total expenditure		45.9	44.6	48.4	48.7	47.8
Primary current expenditure		31.6	32.4	32.6	33.3	33.7
Interest payments		10.5	7.8	7.5	7.1	6.6
Investment		3.2	3.6	4.0	4.1	4.2
Primary balance [2)]		2.8	4.7	5.7	6.1	6.6
Government debt	107.9	111.3	105.0	103.9	102.7	99.8
Cyclically-adjusted balance [4)]		-7.0	-2.9	-1.7	-1.1	-0.8
Cyclically-adj. primary balance [4)]		3.5	4.9	5.8	6.0	5.8

Note : For footnotes and sources see Table 1.2 for Belgium

4.4.1 Labour markets

- **Overall assessment**

13. Despite some recent employment creation, the Greek labour market is characterised by a low employment rate (55.7 per cent in 2000) and a high level of structural unemployment. Moreover, the labour market seems to be highly segmented with high rates of youth and female unemployment, and a high share of long-term unemployment.

14. Some progress was made in implementing the 2001 labour market recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendations in the 2001 BEPGs	*Degree of implementation*
➢ Ensure the full implementation of recent labour market reform packages, and further build upon these efforts by loosening restrictive employment protection legislation in particular.	In progress
➢ Eliminate major distortions arising from labour taxes and pension entitlements, thus improving incentives to take up work in the formal sector.	Partial
➢ Ensure that wages better take into account productivity and local labour market conditions, in particular by making opt-outs including in territorial employment pacts a practical possibility.	No new measures
➢ Increase investment in and improve educational and training systems in order to enhance the skills of the labour force.	In progress

15. The legislation for labour market reforms adopted in December 2000 entered into force on 1 April 2001. It is therefore somewhat early to assess whether these measures will result in improvements in labour market performance. However, problems with the implementation and take-up of measures included in the 1998 reform package suggest that this needs to be closely monitored. No measures have been taken to reform employment protection legislation since the December 2000 package, which in fact served to tighten employment protection legislation for some sizes of enterprise.

16. Over the last few years the Greek government has taken a number of measures to cut taxes in order to promote both labour demand and supply. Despite recent measures, some of the fundamental distortions introduced by the tax system still remain. These include the relatively strong degree of progressivity of personal income tax rates, and a higher burden on dependent employees compared with the self-employed. These distortions, combined with other features of the labour market, contribute to promoting the informal sector. Moreover, some of the recent incremental measures only seem to increase the complexity of the tax system. Decisions on the scale and scope of a more fundamental the reform of the tax system will be taken in 2002. The reform will aim, *inter alia*, to widen the tax base, and further reduce high marginal rates. On the other hand, the planned reform of the pensions system continues to be delayed, with no concrete decisions taken in 2001.

17. No changes have been made to the system of wage formation, which is relatively centralised, and which does not allow wages to reflect differences in productivity across regions, firms, or workers. Similarly, no measures have been taken to ensure that recourse to the opt-out from sectoral agreements, introduced by the Territorial Employment Pacts, is a practical possibility; this opt-out has only ever been used on one occasion.

18. There are a number of different initiatives to improve the educational system, many of which are part of the wide-ranging educational reform programme introduced in 1998. In the compulsory education sector, reforms are aimed at reducing school drop-outs; improving primary and nursery education; and enhancing teaching resources. Other measures aim to strengthen vocational training; raise adult literacy; modernise university education; enhance links with business; and address specific perceived skills

shortages. The latest data from Eurostat suggest that public spending on education over the last two or three years has been growing at around the same pace as GDP.

Table 4.3: **Labour market indicators for Greece**

	Greece					EU			USA		
	1990	**1994**	**1999**	**2000**	**2001**	**1994**	**2000**	**2001**	**1994**	**2000**	**2001**
Employment rate (ER) [1)]	54.6	54.2	55.3	55.7	:	59.6	63.2	:	72.0	74.1	:
Female ER [1)]	37.1	37.3	40.6	41.2	:	49.3	54.0	:	65.2	67.9	:
Older workers ER [1)]	41.0	40.1	39.1	38.6	:	35.7	37.7	:	54.4	57.7	:
Employment growth [2)]	1.3	1.9	-0.7	-0.3	1.1	-0.1	1.7	1.1	2.3	1.9	-0.1
ER full time equivalent	:	53.8	54.5	55.3	:	54.9	57.9	:	:	:	:
Unemployment rate (UR)	6.4	8.9	11.6	11.1	:	11.1	8.2	7.8	6.1	4.0	4.8
Long-term UR [1)]	3.4	4.4	6.5	6.1	:	5.2	3.6	:	:	:	:
Youth UR (<25)	21.5	27.7	31.3	29.6	:	22.1	16.2	15.5	12.4	9.3	10.6
Nominal wage growth [2)]	17.9	10.9	4.8	6.1	5.5	3.1	3.0	3.3	2.4	5.1	5.3
Real Unit Labour Cost growth [2)]	-0.9	-0.5	-2.2	-1.9	-0.8	-2.4	-0.1	0.3	-1.1	0.7	1.8
Labour Productivity growth [2)]	-1.3	0.1	4.1	4.6	3.0	2.9	1.6	0.5	1.5	2.1	1.0
Tax rate on average wage earners [3)]	:	35.1	35.7	36.0	36.0	44.6	43.6	43.0	31.2	30.8	30.0
Tax rate on low wage earners[3)]	:	:	34.3	34.3	34.3	:	38.6	37.8	:	29.0	27.7
NRR on low income families (married) [4)] *	:	46.0	44.0	:	:	72.0	67.0	:	59.0	59.0	:
NRR on low wage earners (single) [4)] *	:	55.0	48.0	:	:	71.0	68.0	:	59.0	59.0	:

* NRR data for Greece are for 1997 and 1999.

Note: For other footnotes and sources see Table 1.3 for Belgium.

4.4.2 Product markets and the knowledge-based economy

- **Overall assessment**

19. Partly due to its geographical location the Greek economy is relatively less open (as measured by the total trade-to-GDP ratio) than any other Member State. Price levels are below the EU average due to lower income and tax levels, and labour productivity is the second lowest in the EU, although rising strongly in recent years. The Single Market transposition deficit was more than halved but, at 3%, is still the highest in the EU. The costs to set up a new business are relatively high and, although the corporate effective tax rates are relatively low and an overall tax reform is underway, the system of corporate taxation is still relatively complex and possibly constrains firms' incentives to grow. There is still room for improving the overall efficiency and effectiveness of the public institutions, including in the application of competition policy. Also due to the recent liberalisation, the market position of incumbents in network industries remains strong.

20. The levels of education attainment of the population are relatively low, partly due to the below EU-average public expenditures in education as a share of GDP. Greece is also

one of the weakest innovators in the EU, as shown by the low levels of R&D investment (total and particularly by the business sector) and several performance indicators (number of patents and scientific publications, participation in innovation co-operation etc.). Despite progress made, overall ICT diffusion remains below the EU average.

21. Greece has made some progress in implementing the 2001 product markets recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendations in the 2001 BEPGs	*Degree of implementation*
➢ Continue to reduce the regulatory and administrative burden on business, enhance the performance of the public administration and improve the coherence of the corporate taxation system	Partial
➢ Take additional measures to increase R&D spending	No new measures
➢ Continue to promote the wider diffusion of ICT and the use of e-commerce	In progress
➢ Improve the transposition record of Internal Market legislation, particularly in the area of public procurement	2
➢ Speed up the liberalisation of the gas sector, implement the reform of sea transport as announced and reinforce competition in already liberalised utilities	Partial

22. Efforts were made to reduce the administrative burden on businesses and foster entrepreneurship, with particular emphasis on start-ups and SMEs. This has led to a decrease in the delays and costs associated with setting up a new company, although costs remain rather high by EU standards. To improve the quality of public services to citizens, 2 information one-stop-shops were set up in the framework of the Politeia programme. Besides this no specific measure was adopted to enhance the performance of the public administration. An overall-tax reform is underway, aimed at simplifying the current system. Some of the measures introduced during 2001 (such as the abolition of a large number of stamp duties) have reduced the burden for firms. However, the system of corporate taxation is still relatively complex and the latest incentives approved (particularly the temporary reduction of corporate income tax for companies which merge) appear partial responses to redress the bias in favour of the self-employed and small businesses.

23. The National Report mentions that action has been undertaken to increase R&D spending, without however providing further details. A legal framework for university spin-offs was recently introduced.

24. The EU co-financed Community Support Framework 2000-2006 includes a comprehensive Operational Programme for the information society, setting out a comprehensive strategy for diffusing ICT: in the public administration (e.g. public procurement and taxation), in education (e.g. internet connection in schools, teachers' training), in business (including e-commerce) and in improving the quality of life. Internet connection by very small businesses will be subsidised. There are also plans to develop ICT skills in wider segments of the population. These measures should promote

the further use of ICT, whose overall diffusion remains relatively low compared to the EU average.

25. Greece made good progress in reducing the transposition deficit of Internal Market directives, which fell from 6.5% in 2000 to 3% in 2001. At this level, the transposition deficit still remains the highest in the EU, with delays concerning in particular the transposition of directives on the environment and veterinary legislation. Progress was also achieved in the area of public procurement.

Table 4.4: **Product market indicators for Greece**

	GREECE				EU 15			
	1998	1999	2000	2001	1998	1999	2000	2001
Labour productivity[1]	75.7	79.0	81.7	83.6	100	100	100	100
Relative price levels[2]	80.0	82.0	80.0		100	100	100	
Total trade to GDP ratio (%)[3]	16.9	16.7	17.2	17.1	41.2	41.9	46.7	45.8
FDI share[4]					2.7	5.0	8.9	
Cross-border M&A share[5]	0.7(1.4)	1.0(1.4)	1.1(1.4)		100	100	100	
Single Market Directives[6]	5.2	6.2	6.5	3.0	3.9	3.6	3.0	2.0
Value of tenders in the O.J.[7]	5.8	5.1	4.3		1.8	1.8	2.4	
Sectoral and ad hoc State aids[8]	0.8	0.7			1.0	0.9		
Prices in telecommunications[9]								
- Local	0.18	0.21	0.31	0.36	0.41	0.41	0.41	0.41
- National	3.15	2.78	1.40	0.98	2.16	1.69	1.34	1.15
- Call to USA	5.82	5.82	3.26	2.91	5.07	4.09	3.39	2.65
Market share fixed telecom (%)[10]								
- Local		100.0	100.0					
- Long Distance		100.0	100.0					
- International		100.0	100.0					
Electricity prices[11]								
- Households	5.96	6.21	5.54	5.83	10.57	10.48	10.40	10.33
- Industry users	5.58	5.82	5.61	5.9	6.44	6.32	6.44	6.33
Market share electricity (%)[12]		98						
Education expenditure[7]	3.5	3.7	3.5	3.5	5.0	5.0	5.1	
New S&T graduates[13]								
R&D expenditure[7]		0.68			1.87	1.92	1.90	
Internet access at home[14]		3.0	11.7	11.7		12.0	28.4	36.1
Patent applications[15]	7.1	8.1	5.2		129.9	140.9	152.7	

Note: For footnotes and source see Table 1.4 for Belgium.

26. The authorities have announced that the gas sector will be opened up before the end of the derogation in 2006 and, in preparation, the gas monopolist DEPA has submitted to the energy regulator a new pricing system. The partial privatisation of DEPA is also planned. The domestic ferry transport should be liberalised in 2002, and a regulatory agency for maritime transport is being set up. Greece is the only Member State still benefiting from a derogation on the coastal shipping sector. The electricity market started to be liberalised in 2001 but remains the most concentrated in the EU, with the incumbent (PPC) maintaining a strong influence on the overall market. There is a need to construct new generation capacity and allow new entrants. A first public offering of

PPC's equity was carried out in late 2001. Fixed telecommunications were liberalised in early 2001, but there are some delays in the introduction of effective competition to the incumbent OTE. Postal services are also being opened up according to EU requirements.

4.4.3 Capital markets

- **Overall assessment**

27. While Greek bond markets rallied due to the integration into the euro area, Greek equity markets had to cope with an adverse external environment in 2001. Stocks listed on the Athens Stock Exchange (ASE), which officially joined the world's "mature" markets only in May 2001, suffered from price falls, low liquidity and had difficulties in attracting more long term investors. However, efforts have been made to enhance ASE's attractiveness by creating a more integrated operating framework and increasing transparency. The possibility of alliances with major European and Southeast European exchanges is currently discussed and a co-operation agreement with the Belgrade Stock Exchange was signed in December 2001. The privatisation and consolidation process continued in the Greek banking sector and government influence on the banking sector has been further reduced. The merger of the two largest Greek banks, National Bank of Greece and Alpha Bank, seems however to have failed in January 2002.

28. After passing several laws to modernise the financial system in 2000, the regulatory and operational framework of the capital markets has been only gradually adapted during 2001. The role of the "Capital Market Commission" has been strengthened by a full transfer of regulatory powers from the Ministry of National Economy (MNE). It now carries out reform initiatives in several fields (code of conduct for listed companies, Principles of Good Governance in Greece, supervision).

29. In the field of financing technology and knowledge intensive sectors, the Greek Venture Capital market remains below the EU average. A Venture Capital Fund (TANEO) has been established to stimulate the availability of finance for early-stage technology businesses and to provide them with administrative support and consultation services. The operation of the New Economy Fund S.A, a recently established joint public-private initiative "fund of funds" with a Euro 300 million capital, is expected to lead to the creation of a number of VC funds. In addition, a Loan Guarantee Scheme has been created to support and facilitate the access of SMEs to the capital markets through a mechanism of balanced risk allocation. Tax incentives have been granted for SME mergers.

30. Some progress was made in implementing the 2001 capital market recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendation in the 2001 BEPGs	*Degree of implementation*
➢ Develop further the risk capital market by easing quantitative constraints on institutional investment in equity capital, by establishing a fiscal framework that is conductive to investment and entrepreneurship, the latter to be also encouraged by adjusting bankruptcy laws.	In progress

31. With regard to the development of risk capital markets, publicly financed initiatives and tax incentives for SME mergers have been put in place. In addition, in a bill submitted to Parliament, the government has proposed full "tax transparency" in the tax treatment of risk capital funds, a new legal framework for the creation of venture capital funds and favourable tax treatment for R&D expenditures. However, no efforts to ease quantitative constraints on institutional investment and, improve bankruptcy legislation or change the fiscal framework to stimulate investment and entrepreneurship have been reported.

5. SPAIN

5.1 Macroeconomic context

1. After having grown by around 4% annually between 1997 and 2000, economic activity slowed down in 2001 due to the impact of oil and unprocessed food price hikes earlier in the year and subsequently in response to the international downturn. Against this backdrop, Spanish growth has shown resilience and is expected to post a figure of around 2.7% in 2001. In 2002, output growth should further decelerate to 2.0%, although with a recovery gaining strength through the year as the international setting improves. In line with this macroeconomic scenario, employment creation in 2001, while remaining positive, lost some of the dynamism shown in previous years and is expected to continue decelerating in 2002. As a result, the fall in unemployment should halt with the rate barely changed at around 13% in 2001 and 2002. The HICP accelerated slightly to 3.6% on average in 2001 reflecting not only the adverse behaviour of the most volatile components but also an increase in core inflation. For 2002, inflation is expected to fall to 2.3% as result of a deceleration in import prices, more favourable food price developments and weaker domestic demand.

Table 5.1: **Economic developments in Spain**[1)]

	1992-97	1998	1999	2000	2001
Real GDP	1.9	4.3	4.1	4.1	2.7
Domestic demand	1.3	5.7	5.6	4.2	2.8
Private consumption	1.4	4.5	4.7	4.0	2.6
GFCF (Investment)	0.4	9.7	8.8	5.7	3.8
Exports (G&S)	11.1	8.2	7.6	9.6	4.9
Imports (G&S)	7.4	13.3	12.8	9.8	5.0
Inflation [2)]	:	1.8	2.2	3.5	3.6
Compensation/employee	5.4	2.7	2.7	3.4	3.9

Note: For Footnotes and sources see Table 1.1 for Belgium.

5.2 Key challenges

2. Whereas Spain made progress in implementing the recommendations of the 2001 BEPGs, a number of key policy issues require continued attention, in particular the long-term sustainability of public finances, the still high unemployment rate, the low employment rate, especially for women, and the relatively high underlying inflation combined with a slowdown of productivity growth.

Key economic policy challenges for Spain

- Improving the long-term sustainability of public finances, especially by reforming the pensions system.
- Reducing the still high unemployment and wide regional unemployment disparities, highlighting the need to reform the collective bargaining system and reduce barriers to labour mobility.
- Increasing the low employment rate, especially among women.
- Tackling a relatively high level of underlying inflation combined with a slowdown of productivity growth, the latter being indicative of an insufficient degree of competition in some sectors, and a lag in the development of the knowledge-based economy.

3. The long-term sustainability of public finances is not yet assured, given the particularly rapid population ageing projected for Spain and the lack of reform of the pension system. Although strong job creation in the recent past has resulted in the current social security sub-sector surplus of 0.5% of GDP, estimates point to pension expenditure as a percentage of GDP increasing from 9.4% in 2000 to 17.7% in 2050, with a marked worsening between 2020 and 2030. The latest agreement on pensions of March 2001 did not address the main problems, in particular contribution requirements, the alignment of the special regimes with the general regime and the parameters behind pension calculations. So far, the main measure adopted to deal with ageing is a social security fund created in 2000 to finance future liabilities. Assets in the fund are planned to reach at least 1% of GDP in 2004.

4. Despite the substantial fall in unemployment over the past decade, it still remains the highest in the EU, at 13.1% in 2001, and very unevenly distributed, with female unemployment at double the rate for males and youth unemployment still very high at 25%. Mainland regional unemployment rates range from 5.9% to 22.6% (national LFS, 2001/Q3). This highlights the need to reform the collective bargaining system so that wage developments better reflect differences in productivity and local labour market conditions, and to reduce barriers to labour mobility, such as rigidities in the housing market and regional benefit schemes for seasonal workers.

5. Despite very rapid employment growth in recent years, the overall employment rate remains very low, at 54.7% for the full year 2000. The employment rate of women has grown even faster but also remains very low at 40.3% in 2000. The employment rate of older workers, at 36.6%, is low but not particularly so relative to total employment. This highlights the need for continued efforts to promote increased labour supply, especially among women.

6. Structural reforms have been successful in terms of employment creation in recent years. However, productivity growth – on average 0.8% per person employed over the period 1994-2000 as compared to 2.3% over the period 1987-1994 – has not been as satisfactory as might be expected for a catching-up economy, and underlying inflation remains high, at 3.7% year-on-year in December 2001 compared to 3.4% in the same month one year ago. The poor productivity performance is partly due to very rapid employment growth but other reasons could play a role as well. The educational attainment of the population is low and spending in education as a percentage of GDP is among the lowest in the EU. The development of the knowledge-based society lags

behind the EU average in terms of business R&D, patents and take-up of ICT and its impact on productivity gains is still very limited. Competition in network industries, has improved, but the market share of incumbents remains high. In non-tradable services, retail distribution and pharmacies are subject to strict entry barriers.

5.3 Public finances

- **Overall assessment**

7. Since the mid-1990s, fiscal consolidation has made clear progress in reducing the general government deficit from 6.6% of GDP in 1995 to 0.3% in 2000. In general, this achievement has been based on expenditure restraint and supported by the brisk economic growth registered in recent years. In 2001, despite weaker output growth than previously assumed, these positive results continued, reaching the official target of a general government balanced budget.

8. The 2001 update of the stability programme, covering the period 2001-2005, confirms the balanced budget target set for 2001 and extends it to 2002 and 2003. The targets for 2004 and 2005 are general government surpluses of 0.1% and 0.2% of GDP, respectively. The debt-to-GDP ratio, already below 60% of GDP, is set to continue its decline, reaching 50% of GDP by 2005. The fiscal consolidation strategy remains unchanged compared to previous programmes, relying on primary current expenditure constraint and lower interest charges, while capital expenditure is set to increase and the tax burden should be reduced slightly.

9. Good progress was made in implementing the 2001 public finance recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendations in the 2001 BEPGs	*Degree of implementation*
➢ Achieve a budgetary position of balance for 2001 as set in the updated stability programme, especially through primary current expenditure restraint. Moreover, there should be a readiness to tighten fiscal policy further to counterbalance additional inflationary pressures.	2
➢ Prepare the 2002 budget aiming at the target of the 2001 updated stability programme. Should inflationary pressures persist, any better than expected results in 2001 should be carried forward and fiscal policy tightened further. Additionally, ensure that the fiscal reform envisaged for 2002 is supply-side-oriented and does not jeopardise the stability programme budgetary objectives.	2
➢ Increase the public pension fund reserve created in the 2000 Budget Law to at least 1 per cent of GDP by 2004, as envisaged in the latest updated stability programme. Additionally, legislate already in 2001 for a comprehensive overhaul of the public pension system to ensure its future viability.	Partial

10. The balanced budget target in 2001 was met chiefly through current expenditure containment - strong social security receipts, which partially offset the fall in other tax revenues. According to Commission estimates, the budget implemented a restrictive fiscal stance. The acceleration of inflation in 2001 reflected in part the adverse

behaviour of the most volatile price components. The relatively high level of underlying inflation is mainly indicative of price convergence pressure, although it could point to an insufficient degree of competition in specific sectors.

11. The 2002 budget aims at a balanced budget target. This compares with a 0.2% of GDP surplus targeted in the 2001 updated stability programme but has to be seen against a background of slower than expected growth and receding inflationary pressures. The 2001 update provides no details on the proposed tax reform, apart from stating that it will be supply-side oriented aiming to stimulate saving, investment and the supply of labour and putting its cost in terms of lost revenues at 0.3% of GDP between 2002 and 2004. The envisaged reduction in the tax burden is compatible with the maintenance of the fiscal consolidation considered in the updated programme.

12. In the previous updates of the stability programme (2000-2004) the pension fund reserve was to be gradually increased up to at least 1% of GDP in 2004. This target is confirmed in the latest update whereas the 2002 Budget Law envisages to increase the fund by €1.1bn (0.2% of GDP) in the current year, reaching a total amount of 0.3% of GDP. By the end of 2001, the total amount of the fund was some € 2.4 bn (0.4% of GDP). However, given that the current social security surpluses are not being fully allocated to the fund, the target for 2004 could be more ambitious. As regards public pension reform, no significant actions were taken in the recent past, since the latest agreement on pensions in March 2001 did not address the crucial issue of the parameters of the system.

Table 5.2: **Trends in public finances in Spain** [1)]

	1994	**1996**	**1998**	**1999**	**2000**	**2001**
Government balance [2)]	-	-4.9	-2.6	-1.1	-0.3	0.1
- Total revenue	-	38.8	39.1	39.7	39.5	39.6
Tax burden [3)]	-	33.8	34.5	35.1	35.7	35.7
- Total expenditure	-	43.7	41.6	40.8	39.8	39.5
Primary current expenditure	-	33.7	32.6	32.2	32.1	31.7
Interest payments	-	5.3	4.3	3.5	3.3	3.2
Investment	-	3.1	3.3	3.3	3.2	3.3
Primary balance [2)]	-	0.4	1.7	2.5	2.9	3.3
Government debt	-	68.1	64.5	63.1	60.4	58.0
Cyclically-adjusted balance [4)]	-	-4.0	-2.5	-1.4	-1.1	-0.4
Cyclically-adj. primary balance [4)]	-	1.3	1.8	2.2	2.2	2.8

Note: For Footnotes and sources see Table 1.2 for Belgium.

5.4 Economic reforms

5.4.1 Labour markets

- **Overall assessment**

13. Extremely rapid employment growth in 2000 means that Spain is catching up in terms of employment rates. However, employment remains very low and unemployment very high, especially among women, the share of fixed-term contracts in total employment is high and severe regional disparities remain.

14. Some progress was made in implementing the 2001 labour market recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendations in the 2001 BEPGs	*Degree of implementation*
➢ Encourage reform of wage formation in order to better take into account productivity and local labour market conditions, and diminish obstacles to labour mobility, inter alia through improvements to the functioning of the housing market and regional benefit schemes.	Partial
➢ Increase investment in and improve education and training, and ensure that active labour market measures are efficient and tailored to the needs of those most prone to the risk of long-term unemployment or those with lower participation rates (in particular women) and to the demands of the labour market.	Partial
➢ Take steps to ensure, with the Social Partners, an appropriate balance between flexibility and security, by means of the effective implementation of recently approved employment contract reforms, with a view to early progress in terms of a reduced share of fixed-term contracts, greater use of the part-time contract and a higher share of female employment.	In progress

15. The government had been encouraging the social partners to agree on a significant reform of the collective bargaining system. The social partners reached an accord in December 2001, but on guidelines for collective bargaining in the next year, not on a reform of the bargaining system. According to the agreement, wage developments will be based on the government's official inflation target (2%), with any excess to be negotiated on the basis of productivity gains, so that wage developments should take account of international competitiveness. Indexation clauses, in case inflation turns out to be higher than the official forecast, may still be included. It is not clear how the new agreement will encourage wage developments that better reflect regional differences in productivity and labour market conditions. The National Action Plan for employment announced some initiatives aimed at encouraging labour mobility. However, some of the principal obstacles, including the housing market and regional benefit schemes, have not been addressed.

16. The National Action Plan for employment shows some progress on the follow-up and monitoring of active labour market policies, although there is no indication that this amounts to the kind of evaluation necessary to ensure that measures are efficient and

tailored to the needs of beneficiaries and employers. Central government investment in education has risen significantly in real terms and will continue to do so in 2002. However, the available figures suggest that overall public spending on education has remained roughly constant as a percentage of GDP in recent years. The government aims to improve the quality of the university system with the draft laws on universities and professional training and grading. More could be done to implement a fully coherent strategy on lifelong learning.

Table 5.3: **Labour market indicators for Spain**

	Spain					EU			USA		
	1990	**1994**	**1999**	**2000**	**2001**	**1994**	**2000**	**2001**	**1994**	**2000**	**2001**
Employment rate (ER) 1)	49.2	45.0	52.5	54.8	:	59.6	63.2	:	72.0	74.1	:
Female ER 1)	30.7	30.3	37.6	40.3	:	49.3	54.0	:	65.2	67.9	:
Older workers ER 1)	36.8	32.3	34.9	36.8	:	35.7	37.7	:	54.4	57.7	:
Employment growth 2)	3.6	-0.5	3.5	3.1	2.3	-0.1	1.7	1.1	2.3	1.9	-0.1
ER full time equivalent	:	43.5	50.2	52.5	:	54.9	57.9	:	:	:	:
Unemployment rate (UR)	16.2	24.1	15.9	14.1	13.1	11.1	8.2	7.8	6.1	4.0	4.8
Long-term UR 1)	8.2	12.9	7.3	5.9	:	5.2	3.6	:	:	:	:
Youth UR (<25)	32.3	45.0	29.5	26.2	24.9	22.1	16.2	15.5	12.4	9.3	10.6
Nominal wage growth 2)	10.2	3.7	2.7	3.4	3.9	3.1	3.0	3.3	2.4	5.1	5.3
Real Unit Labour Cost growth 2)	2.5	-3.0	-0.6	-1.0	-0.3	-2.4	-0.1	0.3	-1.1	0.7	1.8
Labour Productivity growth 2)	0.2	2.9	0.5	1.0	0.4	2.9	1.6	0.5	1.5	2.1	1.0
Tax rate on average wage earners 3)	:	38.8	37.5	37.6	37.9	44.6	43.6	43.0	31.2	30.8	30.0
Tax rate on low wage earners 3)	:	:	32.6	32.8	33.3	:	38.6	37.8	:	29.0	27.7
NRR on low income families (married) 4)	:	76.0	72.0	:	:	72.0	67.0	:	59.0	59.0	:
NRR on low wage earners (single) 4)	:	71.0	76.0	:	:	71.0	68.0	:	59.0	59.0	:

Note: For footnotes and sources see Table 1.3 for Belgium.

17. It is too early to assess fully the effects of the reforms of employment contracts adopted in March 2001. However, these seem to move in the right direction in terms of increasing labour market flexibility while going some way towards redressing the balance between permanent and temporary contracts and at the same improving the part-time contract. The fact that the reform was adopted without the full support of the social partners does not appear to have adversely affected the social dialogue on other issues. Although the share of temporary contracts in employment has remained roughly stable in recent years, it may well be that previous reforms, notably in 1997, could have helped to prevent it from rising further. However, employment protection for those on permanent contracts remains very high and employers are still subject to strong incentives to hire people on short-term temporary contracts.

5.4.2 Product markets and the knowledge-based economy

- **Overall assessment**

18. Spain has continued its integration into the European goods market and is well advanced in terms of transposition of internal market legislation. However labour productivity is below the EU average and its growth has slowed since the 2nd half of the 1990s. Some non-tradable services, such as retail distribution and pharmacies, are still subject to entry barriers. State Aids have steady declined but remain above the EU average in percentage of GDP. Network industries are becoming progressively more open to new entrants, which has started to benefit users in terms of lower prices and wider product choice with better match to their needs, but the market share of incumbents remain high. Finally, the time and cost to create a new company is relatively high, especially for sole owners.

19. In the area of R&D and patents, in part owing to lower R&D business expenditure, Spain is well below the EU average. Similarly, the public expenditure on education is below the EU average. The uptake of ICTs in the population remains low, although internet access at home is increasing at double-digit rate, and the fruits of the measures adopted by the government should appear progressively.

20. Good progress was made in implementing the 2001 product market recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendations in the 2001 BEPGs	*Degree of implementation*
➢ Take measures to increase the basic ICT skills of the population and to increase the supply of highly qualified research and ICT personnel.	In progress
➢ Continue the implementation of the plan to simplify the regulatory framework for SMEs.	In progress

21. The government launched the "National Plan for scientific research and technological development and innovation" and the "Info XXI Initiative Action Plan" which will be completed in 2003. These plans include, among other measures, tax incentives to R&D activities, incentives to mobility of research staff, provision of early stage capital for the creation of technology-based companies, initiatives to provide better ICT training to users and professionals in well equipped training centres. It is still too early to assess fully the effects of these initiatives and the degree of diffusion between all the segments of the population but these initiatives go in the right direction.

22. Two main actions were taken by the government. A network of fifteen "One Stop Shops for businesses" was developed to provide future entrepreneurs with advice on the formalities required to start up a business. A "Plan for Speeding-up and simplifying regulations for the competitiveness of SMEs" was implemented to reduce and, where appropriate, remove administrative obstacles that prevent business from achieving their maximum potential. However, the general perception is that there is still room to improve the legal and regulatory framework in which SMEs and sole owners operate. The government has recently presented a new project, which will be discussed in the Parliament in 2002. The project intends to unify all the formal requirements for new

enterprise creation and the completion of these formalities on line. The government considers that the creation of new companies could be made effective within 2 days.

Table 5.4: **Product maarket indicators for Spain**

	SPAIN				EU 15			
	1998	1999	2000	2001	1998	1999	2000	2001
Labour productivity[1]	90.4	92.4	91.9	91.9	100	100	100	100
Relative price levels[2]	84.0	83.0	83.0		100	100	100	
Total trade to GDP ratio (%)[3]	21.2	20.0	24.2	22.7	21.7	21.8	24.8	24.7
FDI share[4]	2.0	2.8	6.5		2.7	5.0	8.9	
Cross-border M&A share[5]	5.8(6.9)	5.3(6.9)	5.6(7.1)		100	100	100	
Single Market Directives[6]	2.7	2.2	1.6	1.3	3.9	3.6	3.0	2.0
Value of tenders in the O.J.[7]	1.5	2.9	3.3		1.8	1.8	2.4	
Sectoral and ad hoc State aids[8]	1.2	1.1			1.0	0.9		
Prices in telecommunications[9]								
- Local	0.32	0.31	0.28	0.28	0.41	0.41	0.41	0.41
- National	3.55	2.62	1.85	1.60	2.16	1.69	1.34	1.15
- Call to USA	6.08	4.53	4.25	4.25	5.07	4.09	3.39	2.65
Market share fixed telecom (%)[10]								
- Local		99.0	94.0					
- Long Distance		91.0	86.0					
- International		89.0	86.0					
Electricity prices[11]								
- Households	9.46	9.14	8.95	8.59	10.57	10.48	10.40	10.33
- Industry users	6.20	6.24	6.36	5.50	6.44	6.32	6.44	6.33
Market share electricity (%)[12]		44.7						
Education expenditure[7]	4.4	4.5	4.5	4.4	5.0	5.0	5.1	
New S&T graduates[13]	8.0	9.6						
R&D expenditure[7]	0.90	0.89	0.90		1.87	1.92	1.90	
Internet access at home[14]		6.0	15.7	23.4		12.0	28.4	36.1
Patent applications[15]	21.1	23.4	22.1		129.9	140.9	152.7	

Note: For footnotes and source see Table 1.4 for Belgium.

5.4.3 Capital markets

- **Overall assessment**

23. The sharp reversal in world financial markets conditions in 2001 has caused a temporary setback in the long term trend to increasing liquidity and trading volumes and a more diversified investment choice in the Spanish capital market. The stock markets have experienced a significant correction after several years of buoyant growth, with the Nuevo Mercado being the most affected. Government bond issuance volumes decreased due to fiscal consolidation. The Spanish financial derivatives market has been developed further by the launch of individual share futures on five of the IBEX-35 majors at the beginning of 2001. The merger of the derivatives market, the main corporate debt market and the organised trading system for government debt into Mercados Financieros has been the first step towards full-scale integration of Spanish financial markets. On 15, February 2002, Mercados Financieros, the four regional exchanges and the company which manages Clearing and Settlement will merge to become Bolsa y Mercados Españoles, Europe's fourth largest exchange in terms of

trading volumes. Private insurance activity continued to expand, while consolidation increased the number of larger and more solvent companies.

24. The Securities Market Law has been amended to allow for stock market demutualisation, removing a major market entry barrier. Two Royal Decrees (867/2001 and 91/2001) liberalised the legal regime of investment services firms and laid down more flexible conditions for the creation, authorisation and operation of new collective investments in transferable securities (UCITS). The draft Finance Law foresees different measures to enhance the functioning of the Spanish capital market such as the unification of securities clearance and settlement systems, the definition of a legal framework for electronic trading and transposition of Community directives on electronic money. Regarding pension funds, progress continued in the externalisation of corporate pension liabilities to occupational pension schemes or group insurance companies. Changes in the tax treatment of pension plans aim at encouraging private retirement saving and, in particular, occupational pension schemes.

25. Spain has made efforts to improve investor protection. An Investor Guarantee Fund was installed and the monitoring and supervisory powers of the National Securities Markets Commission over investment funds were strengthened. The draft Finance Law foresees new transparency standards for investment companies, tighter rules on insider information and certain organisational limitations on firms providing securities market services. Regarding prudential supervision the Bank of Spain and competent local agencies signed protocols to improve the oversight of Spanish banking groups operating in Latin America.

26. To facilitate SME financing the draft Finance Law foresees measures to broaden access to factoring and improvements to the regulation and treatment of mortgage loan securitisation. It also clarifies the concept of risk capital providers, relaxes some current rules and includes continuing entitlement to tax benefits after the market flotation of investee companies as well as simpler rules for channelling investments through holding companies. Risk capital funds and companies have also been given a more advantaged tax treatment via an exemption on capital gains raised from the transfer of equity interests in investee companies, which shall be 99% as of the second and up to and including the twelfth year.

27. Good progress was made in implementing the 2001 capital market recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendation in the 2001 BEPGs	*Degree of implementation*
➢ Develop further the risk capital market by further easing constraints on institutional investors which may limit their investment in equity capital, and by establishing a fiscal framework more conducive to investment and entrepreneurship, the latter to be also encouraged by adjusting bankruptcy laws.	In progress

28. Spain has conceived several incentives to develop further its risk capital market such as tax incentives for risk capital funds foreseen by the new Finance Law or the creation of a new regulated fund type specialised in unlisted securities to channel investment to SMEs. Progress on adjusting bankruptcy laws to encourage entrepreneurship has not been reported.

6. FRANCE

6.1 Macroeconomic context

1. After three years of robust GDP growth, economic activity decelerated markedly since the beginning of 2001. This slowdown reflects the impact of the global downturn: the sharp decrease in world trade led to a contraction in exports and firms reacted rapidly by adjusting the level of inventories and by postponing investment projects. By contrast, private consumption remained dynamic allowing the economy to avoid an even more severe slowdown. Altogether, GDP growth is likely to remain around 2% in 2001, down from the above 3% average registered between 1997 and 2000. The deterioration in economic conditions affected the labour market: employment growth slowed and the unemployment rate increased, following three years of gradual decline. As a result, wage growth remained very moderate, also reflecting a reduction in working time. After reaching a peak in May, HICP inflation decreased to an estimated 1.8% by the end of the year.

Table 6.1: **Economic developments in France**[1)]

	1992-97	1998	1999	2000	2001
Real GDP	1.2	3.4	2.9	3.1	2.0
Domestic demand	0.7	4.0	3.1	3.3	1.7
Private consumption	1.1	3.2	2.7	2.5	2.6
GFCF (Investment)	-0.8	7.0	6.2	6.1	2.8
Exports (G&S)	5.9	8.3	4.0	12.6	3.0
Imports (G&S)	3.7	11.6	4.7	14.2	2.3
Inflation [2)]	1.9	0.7	0.6	1.8	1.8
Compensation/employee	2.8	2.3	2.4	1.9	2.2

Note: For footnotes and sources see Table 1.1 for Belgium.

6.2 Key challenges

2. Whereas France made progress in implementing the recommendations of the 2001 BEPGs, a number of key policy issues require continued attention, in particular the low labour market participation and high structural unemployment rate, the health and pension systems, the control of public expenditure and the slow liberalisation of network industries.

Key economic policy challenges for France
• Increasing labour market participation and reducing the high rate of structural unemployment.
• Tackling health and pension reform to assure the sustainability of public finances.
• Ensuring the control of public expenditure, in particular in the health sector.
• Accelerating the liberalisation of network industries and the adoption of internal market measures, including the opening up of the markets to foreign competition.

3. In the coming years, the primary policy challenge will be to address the key structural issues on the labour market. In particular it will be necessary to further promote labour supply and to tackle the high level of structural unemployment. In the context of an ageing population and a reduction in statutory working hours, encouraging people into the labour market will be essential. Furthermore, France has a relatively low overall employment rate and a very low employment rate for older workers (one of the lowest in the EU). One of the factors hindering increased participation is the pension regime, including a wide array of early retirement schemes. In addition, the tax and benefit system still provides few incentives for low-paid workers to take up and remain in work. Along with increasing participation it will also be necessary to tackle the continuing high rate of structural unemployment. Unemployment remains particularly high among young persons and women, suggesting problems of insertion of new entrants into the labour market. This problem of labour market segmentation appears to reflect remaining rigidities in the labour market.

4. Population ageing will pose a significant burden on public expenditure on pensions and health care in future years. However, so far, the only significant policy measure taken has been the creation of a pension reserve fund. Nevertheless, as recognised by the French authorities, this fund will not be a sufficient response and the long-term sustainability of the pension system remains a major source of concern. This suggests the need for a comprehensive reform, which has been delayed for several years.

5. The French budgetary strategy is based on defining norms for the increase in real expenditures, set to grow slower than GDP. It is thus a source of concern that multi-annual spending norms fixed in the stability programmes have been consistently revised upwards in the past. Particular attention should be paid to three main areas: the evolution of health expenditures, which have systematically overshot ambitious projections in the last few years; the dynamism of the wage bill in the public sector; and the asymmetric behaviour of planned real expenditures with respect to inflation surprises (when actual inflation turns out to be lower than expected, norms are overshot; yet the reverse happens only very partially).

6. The gas and electricity markets remain among the least open to competition in the EU, with the degree of liberalisation limited to the minimum required by EU directives, i.e. 20% and 30% of the industry users market respectively. France transposed the EU directive on electricity liberalisation in February 2000, while the deadline was fixed for February 1999, but it has still not taken the legislative measures to transpose the EU directive of June 1998 on the opening of the gas market. In response to the delay in the transposition of the latter directive, the Commission has referred the case to the European Court of Justice in May 2001 However, for electricity and for gas (through

direct application of the provision of the directive), respectively 15% and 30% of eligible consumers changed suppliers. Finally, despite strong progress in the last two years, France has a poor record in transposing single market directives (the second worst in the EU) and in implementing these directives (France accounts for the largest number of infringement proceedings before the European Court of Justice).

6.3 Public finances

- **Overall assessment**

7. When presenting the budget for 2002, the French authorities revised their estimate for the general government deficit in 2001, now projected to remain at 1.5% of GDP, the level reached in 2000, while a decline to 1% was initially expected in the budget. To counter the economic slowdown, the French government let the automatic stabilisers play on the revenue side and introduced in October a corrective budget bill containing one-off counter-cyclical measures. But the plan, which came on top of already voted tax cuts worth 1 percentage point of GDP, had a limited impact on the 2001 budget and a very limited one thereafter.

8. The non achievement of the deficit target fixed in the 2001 budget bill is to be largely attributed to the deterioration of cyclical conditions, which engendered lower-than-expected tax revenues. The general government expenditures in real terms, a pivotal variable of the French budgetary strategy, increased in line with the budget plans. However, for the second consecutive year, nominal expenditures were more dynamic than planned as inflation was higher than projected.

9. Some progress was made in implementing the 2001 public finance recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendations in the 2001 BEPGs	*Degree of implementation*
➢ Achieve in 2001 a general government deficit of 1% of GDP (excluding UMTS receipts) as targeted in the 2000 updated stability programme; to this aim, ensure that the increase in real government expenditure will not exceed the projected 1.8% in 2001.	Partial
➢ In the framework of the budget for 2002, contain government expenditures in real terms within the 1.6% limit set by the government in order to secure the achievements of the 0.6% government deficit target set in the 2000 updated stability programme so as to ensure a surplus by 2004.	No new measures
➢ Allocate in 2002 and beyond, as a matter of priority, any additional available margin to strengthen the budgetary position in order to prepare for long-term challenges, notably the burden for public finances which will result from ageing of population; with a view to securing the long-term sustainability of government finances, to make further progress in reforming the pension system.	Partial

10. Even if the target for the general government deficit initially planned in the budget was not reached, it must be noted that growth in real expenditures was in line with budget plans. Macroeconomic developments affected tax revenues, being the main reason for the non achievement of the deficit target fixed in the 2001 budget bill.

11. The draft budget for 2002 projects a stabilisation in the general government deficit at 1.4% of GDP while the 2000 updated programme targeted a deficit between 0.6% and 1% of GDP depending on the macroeconomic scenario. This revision is due to lower tax revenues and to an upward revision of expenditure plans. Real expenditures are indeed projected to increase by 2.2%. To some extent, however (0.3 percentage point), this rise is attributable to a bringing forward of the implementation of the Berlin agreements on the EU budget, with an increase in the fourth resource (accounted as an expenditure in national accounting), which is broadly neutral on the deficit.

Table 6.2: **Trends in public finances in France** 1)

	1994	1996	1998	1999	2000	2001
Government balance 2)	-5.5	-4.1	-2.7	-1.6	-1.4	-1.5
- Total revenue	49.4	51.4	51.2	51.9	51.4	51.2
Tax burden 3)	43.4	44.8	44.8	45.6	45.2	45.0
- Total expenditure	54.9	55.5	53.9	53.5	52.8	52.7
Primary current expenditure	45.8	46.1	44.8	44.7	44.2	44.3
Interest payments	3.6	3.9	3.6	3.3	3.3	3.2
Investment	3.4	3.2	2.9	2.9	3.0	3.0
Primary balance 2)	-2.0	-0.1	0.9	1.7	1.9	1.7
Government debt	49.6	57.1	59.5	58.5	57.6	57.1
Cyclically-adjusted balance 4)	-5.2	-3.3	-2.4	-1.6	-1.8	-1.9
Cyclically-adj. primary balance 4)	-1.6	0.6	1.2	1.7	1.5	1.3

Note: For footnotes and source see Table 1.2 for Belgium.

12. Given uncertainties surrounding macroeconomic prospects, it is likely that budgetary margins will be very limited in 2002. Little progress was made in reforming the pension system. Moreover, the “Fonds de réserve pour les retraites”, a public fund aiming at smoothing the budgetary impact of ageing populations, was not funded as expected. This is due to the fact that UMTS revenues were lower than expected.

6.4 Economic reforms

6.4.1 Labour markets

- **Overall assessment**

13. Despite high levels of job creation in recent years, the French labour market is still characterised by a relatively low employment rate (62.0% in 2000), particularly for older persons, and a high level of structural unemployment. Moreover, young people and women seem to be disproportionately affected by unemployment.

14. Some progress was made in implementing the 2001 labour market recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendations in the 2001 BEPGs	*Degree of implementation*
➢ Consolidate recent reforms of the tax and benefit system by improving the incentives for older workers to remain in work, and by addressing remaining disincentives to take up part-time and full-time work, in particular for unskilled and low-paid workers. In this context, particular attention should be paid to early retirement schemes and income guarantee schemes.	Partial
➢ Monitor closely the positive and negative effects of the implementation of the 35-hours working week legislation to continue to ensure that it does not generate any adverse medium-term effects on wage costs, labour supply and work organisation.	In progress
➢ Reform employment protection legislation with a view to better combining security with greater adaptability to facilitate access to employment.	No new measures

15. The main measure implemented over the last year to improve the incentives to take up low-paid work has been the introduction of the earned income tax credit. The resources devoted to this tax credit were initially limited, but are set to increase somewhat over time, and an extraordinary payment of the tax credit was announced for January 2002. Nevertheless, some categories of workers still face high marginal tax rates on the return to work. This is firstly because the tax credit seems primarily to benefit full-time rather than part-time work, and secondly because of the eventual withdrawal of income replacement benefits. In general these benefits have no effective job-search condition attached. The removal of the tapering of unemployment benefits in 2000 may have had a negative impact on job search behaviour. Moreover, little has been done to remove the key incentives for early withdrawal from the labour market. There has been no progress on the reform of the public pensions system. Furthermore, there are numerous early retirement schemes in existence, although public schemes and those organised under social partner agreements are being gradually scaled back.

16. Over the last year the implementation of the reduction in working time has been focussed on small- and medium-sized enterprises, which had to change over by the beginning of 2002. As the transition is particularly difficult for these firms, the government has announced that it will be more flexible in the application of legislation, allowing notably a relaxation of over-time limits, and a longer phasing-in. However, the interaction of the reduction of working time with the indexation mechanism for the minimum wage is leading to high levels of nominal increases in minimum wages.

17. On employment protection legislation, the key measure taken in 2001 was the adoption of the law on social modernisation. This legislation increases already high levels of worker protection by strengthening employment protection legislation, but does nothing to promote greater workplace adaptability with a view to facilitating access to employment. The new law attempts to reduce recourse to temporary contracts by increasing the premium paid to temporary workers (from 6% to 10% of salary). Most notably, the new law strengthens rules governing collective dismissals for economic reasons, particularly for large firms, with possible negative effects for labour market dynamics. In particular, the legislation lengthens the dismissals procedure, requires firms to provide additional job-search support for laid-off workers (including paid leave

in large firms), and obliges large firms to become involved in the economic development of affected areas. Another part of the legislation was aimed at narrowing the economic circumstances under which collective dismissals are permitted, but this was subsequently ruled unconstitutional.

Table 6.3: **Labour market indicators for France**

	France					EU			USA		
	1990	**1994**	**1999**	**2000**	**2001**	**1994**	**2000**	**2001**	**1994**	**2000**	**2001**
Employment rate (ER) [1)]	60.7	59.1	60.8	62.0	:	59.6	63.2	:	72.0	74.1	:
Female ER [1)]	51.1	51.6	53.9	55.1	:	49.3	54.0	:	65.2	67.9	:
Older workers ER [1)]	30.7	29.6	29.4	30.3	:	35.7	37.7	:	54.4	57.7	:
Employment growth [2)]	1.0	0.0	1.8	2.2	1.6	-0.1	1.7	1.1	2.3	1.9	-0.1
ER full time equivalent	:	56.1	57.2	58.7	:	54.9	57.9	:	:	:	:
Unemployment rate (UR)	9.0	12.3	11.2	9.6	9.0	11.1	8.2	7.8	6.1	4.0	4.8
Long-term UR [1)]	3.6	4.7	4.4	3.7	:	5.2	3.6	:	:	:	:
Youth UR (<25)	19.8	29.5	24.0	20.3	20.1	22.1	16.2	15.5	12.4	9.3	10.6
Nominal wage growth [2)]	5.1	2.1	2.4	1.9	2.2	3.1	3.0	3.3	2.4	5.1	5.3
Real Unit Labour Cost growth [2)]	0.4	-2.0	0.6	0.1	0.9	-2.4	-0.1	0.3	-1.1	0.7	1.8
Labour Productivity growth [2)]	1.7	2.4	1.3	0.9	-0.2	2.9	1.6	0.5	1.5	2.1	1.0
Tax rate on average wage earners [3)]	:	51.6	48.1	48.2	48.3	44.6	43.6	43.0	31.2	30.8	30.0
Tax rate on low wage earners[3)]	:	:	40.3	39.6	38.4	:	38.6	37.8	:	29.0	27.7
NRR on low income families (married) [4)]	:	79.0	72.0	:	:	72.0	67.0	:	59.0	59.0	:
NRR on low wage earners (single) [4)]	:	85.0	78.0	:	:	71.0	68.0	:	59.0	59.0	:

Note: For footnotes and sources see Table 1.3 for Belgium.

6.4.2 Product markets and the knowledge-based economy

- **Overall assessment**

18. The French economy is relatively open (as measured by the trade-to GDP ratio) and exhibits relatively high labour productivity. The consumer prices have fallen towards the EU average and prices in network industries remain relatively low although the markets share of incumbents is high. State aids have been reduced. However, despite recent progress, the time of registration of a new company remains high and the administrative burdens on business remain among the highest in the EU. Moreover, France's performance in transposing and implementing the internal market legislation is still low.

19. R&D expenditures –total and business- as a share of GDP remain above the EU average and a set of measures aimed at encouraging public and industrial R&D activities, especially for innovative sectors, have been taken. However, R&D expenditures appear to have stagnated over the 1990s. Moreover, the number of patent applications has fallen below the European average since 1998. Internet access and use is less well developed in France than in other EU Member States.

20. Some progress was made in implementing the 2001 product market recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendations in the 2001 BEPGs	*Degree of implementation*
➢ Step up efforts to liberalise network industries, especially the gas and electricity sectors.	No new measures
➢ Continue progress made in transposing internal market directives.	In progress
➢ Continue the reduction of ad hoc State aids.	2
➢ Continue efforts to reduce the administrative burden on business by simplifying procedures and developing new means of electronic communication with the public authorities.	In progress

21. The problems identified in last year's BEPGs concerning the slow liberalisation of the energy sector have not been resolved. As regards electricity and gas markets, France remains one of the few Member States, which have chosen a minimalist opening. In October 2001, 15% of eligible users had cancelled their contract with EDF. The latter intends to sell by auction progressively 30% of its production capacities to new entrants in the eligible market by 2003. The directive on the gas market has not yet been transposed. Since August 2000, Gaz de France applies de facto the provisions of the directive so that eligible consumers can choose their suppliers in Europe freely. 20% of the gas market is open to competition and of this 20%, new entrants have gained within one year a market share of 30%.

22. Although the proportion of outstanding Directives continued to decrease in 2001, France's performance in the field of the transposition of the internal market legislation is still the second worst in the EU. In addition, France accounts for the largest number of infringement proceedings open before the European Court of Justice. A timetable of transposition of the outstanding directives has been announced. If this timetable is respected, it could lead to a substantial reduction of the transposition deficit by spring 2002.

23. Specific state aids were reduced markedly in 2000 and the level of ad hoc state aids continued falling towards the European average in 2001.

24. Efforts made in 2000 to reduce the administrative burden on business have been pursued in 2001. A new electronic procedure for the setting-up, modification, and closure of companies has been introduced. Businesses are now able to complete the VAT form, and pay this tax on-line. Moreover, a reduction in the number of documents requested from enterprises is planned. However, according to a recent survey conducted by the Observatory of European SMEs, the administrative constraints on business remain among the highest in the EU. The Single Market Monitor Survey conducted in September 2001 reveals also that French companies are among the most dissatisfied in the EU with the laws and regulations applying to their sector.

Table 6.4: **Product market indicators for France**

	FRANCE				EU 15			
	1998	1999	2000	2001	1998	1999	2000	2001
Labour productivity[1]	107.8	108.4	108.1	108.1	100	100	100	100
Relative price levels[2]	104.0	105.0	102.0		100	100	100	
Total trade to GDP ratio (%)[3]	21.6	22.2	25.4	25.6	21.7	21.8	24.8	24.7
FDI share[4]	1.89	2.47	3.16		2.7	5.0	8.9	
Cross-border M&A share[5]	15(17.7)	16.4(17)	16(16.5)		100	100	100	
Single Market Directives[6]	5.5	5.6	4.5	3.0	3.9	3.6	3.0	2.0
Value of tenders in the O.J.[7]	1.8	1.9	2.4		1.8	1.8	2.4	
Sectoral and ad hoc State aids[8]	1.2	1.1			1.0	0.9		
Prices in telecommunications[9]								
- Local	0.42	0.42	0.42	0.39	0.41	0.41	0.41	0.41
- National	1.75	1.53	1.20	0.96	2.16	1.69	1.34	1.15
- Call to USA	3.44	3.05	2.97	2.97	5.07	4.09	3.39	2.65
Market share fixed telecom (%)[10]								
- Local		98.4	97.0					
- Long Distance		88.5	79.0					
- International		82.3	74.0					
Electricity prices[11]								
- Households	9.4	9.26	9.12	9.11	10.57	10.48	10.40	10.33
- Industry users	5.78	5.65	5.46	5.51	6.44	6.32	6.44	6.33
Market share electricity (%)[12]		95						
Education expenditure[7]	5.9	5.9	5.8	5.7	5.0	5.0	5.1	
New S&T graduates[13]	18.2							
R&D expenditure[7]	2.17	2.19	2.15		1.87	1.92	1.90	
Internet access at home[14]		8.0	19.0	26.2		12.0	28.4	36.1
Patent applications[15]	124.7	130.0	139.7		129.9	140.9	152.7	

Note: For footnotes and sources see Table 1.4 for Belgium.

6.4.3 Capital markets

- **Overall assessment**

25. The integration of capital markets went one step further in 2001 with the conversion by the three Euronext exchanges of Paris, Brussels and Amsterdam to the same trading platform and the use of a single central clearing house. Since January 2001, responsibility for the issuance of government bonds has been delegated to a new agency so as to ensure that management of public debt is fully in tune with market developments and to lower interest expenses through the use of more specific instruments.

26. In terms of supervision, the draft law for reform of the regulatory and supervisory institutions announced in 2001 (the securities regulatory authorities are to be merged while the banking and insurance supervisory authorities are to co-ordinate more closely) is still under discussion. From an international viewpoint, further to the Euronext merger, the three financial supervisory authorities have agreed to co-ordinate their respective responsibilities (regarding regulation and supervision of Euronext managed markets as well as supervision of clearing activities).

27. Some reforms announced last year were adopted: (i) the law on long term savings plans, which should improve enterprises' access to long-term financing as well as boost demand for equities over the coming years; (ii) the New Economic Regulation bill aimed at improving transparency in the financial system and in company law; (iii) a strengthening of the supervision of clearing systems and their participants, as well as a modernisation of stock exchange functioning. Other proposals for reform (aiming for example at the development of asset management) are under consideration but have not yet been adopted.

28. In the banking sector several measures have been or are being taken to increase consumer protection and prevention of financial exclusion (e.g. creation of a minimum service, measures to improve transparency). The extension of prudential rules in the insurance sector to cover mutual benefit associations with an insurance activity should increase the protection of the members of these associations.

29. There was a notable retrenchment in the risk capital market in 2001, with a strong decline in venture capital investments as well as in funds raised on the stock market compared to the same period of 2000. To compensate for this retrenchment, public funding for young high-tech and biotechnology companies and for incubators has been reinforced.

30. Some progress was made in implementing the 2001 capital market recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendation in the 2001 BEPGs	*Degree of implementation*
➢ Develop further the risk capital market by easing constraints on institutional investment in equities and further adapting the fiscal framework so as to facilitate investment and entrepreneurship, the latter to be also encouraged by adjusting the enforcement of bankruptcy laws	In progress

31. Measures implemented in previous years to encourage risk capital investment (e.g. specific taxation for the enterprise creator share certificates (BSCPE), tax deductibility of capital losses for entrepreneurs, tax relief for investments in venture capital mutual funds (Fonds Communs de Placement à Risque (FCPR)) were further extended in 2001. Taxation for venture capital mutual funds (FCPR) is to be simplified and better adapted to the investment cycles of those funds. Form 2002 onwards the tax-favourable personal equity funds (Plans d'Épargne en Action (PEA)) will be allowed to include investments in venture capital mutual funds.

7. IRELAND

7.1 Macroeconomic context

1. The economy slowed markedly in 2001 as a result of the impact of supply constraints and measures to contain foot-and-mouth disease, coupled with worsened international conditions. After reaching 11.5% in 2000, real GDP growth is expected to have been around 6.5%, mainly reflecting carry-over effects. Economic performance in 2002 will be very much reliant on the timing of the international recovery. Preliminary indications from the purchasing managers' indices for manufacturing and services and from confidence indicators suggest that the worst may have passed. The labour market so far has proved remarkably resilient, with strong employment gains in the first three quarters of 2001 and a limited rise in the unemployment rate to a level just above 4% in December 2001. Given continued tightness of the labour market, earnings growth remains fairly high, with weekly earnings in industry rising 8% year-on-year in the first three quarters of 2001. While annual inflation has moderated from its late-2000 peak, various increases in indirect taxes in the 2002 budget are estimated to add 0.9 percentage points to the inflation rate in 2002. Underlying inflation has risen since mid-2001, pointing to unabated domestically-generated price pressures.

Table 7.1: **Economic developments in Ireland**[1)]

	1992-97	1998	1999	2000	2001
Real GDP	6.7	8.6	10.8	11.5	6.5
Domestic demand	4.9	10.3	6.6	9.2	5.2
Private consumption	4.7	7.3	8.3	10.0	6.2
GFCF (Investment)	8.7	15.7	13.5	7.3	3.4
Exports (G&S)	14.7	21.4	15.7	17.8	9.1
Imports (G&S)	12.7	25.8	11.9	16.6	8.5
Inflation[2)]	:	2.1	2.5	5.3	4.0
Compensation/employee	4.3	4.5	5.3	8.7	9.5

Note: For footnotes and sources see Table 1.1 for Belgium.

7.2 Key challenges

2. Whereas Ireland made progress in implementing the recommendations of the 2001 BEPGs, a number of key policy issues require continued attention, in particular wage growth, the control of public expenditure and the insufficient degree of competition in some sectors.

Key economic policy challenges for Ireland

- Reconsidering the future of the national social partnership agreements in conditions approaching full employment as well as the interaction of wage setting with public finance commitments.
- Improving control of public expenditure in a stability-oriented medium-term framework.
- Addressing the insufficient degree of competition in some sectors, such as retail distribution and network industries.

3. Social partnership is recognised as an important factor in the development of the economy over the last decade. In relation to wages, the current agreement provides for increases in net pay of at least 25% over the period 2000 to budget 2003 through a combination of nominal wage increases and direct tax relief. The agreement also includes commitments to improve public services and infrastructure and to increase social welfare rates. With the agreement due to expire at the end of 2002 (for the private sector), the future of such agreements will arise as an important issue to be addressed in relation to the major changes in the economy, particularly the conditions approaching full employment. Sectoral differences in productivity and skills demand will need to be accommodated in the wage setting process. In addition, the inclusion of considerable, binding public finance commitments in a wage setting framework may give rise to pro-cyclical effects, limit fiscal flexibility and reduce the feasibility of defining and adhering to spending targets.

4. Budgetary policy implementation in the recent past has been characterised by surprises on the upside, with the booming economy buoying tax revenues. However, in 2001, the opposite came to pass, resulting in the lowest surplus ratio since 1997. On the spending side, the budget for 2002 foresees year-on-year growth of around 10%, motivated by a desire to address infrastructural needs and improve public services. Nevertheless, such growth rates are clearly unsustainable and, based on technical projections, the stability programme foresees a return to deficit on the general government balance from 2003. In the course of 2000, the government decided to keep to its self-imposed limit on the nominal growth in net current spending and not to implement previous plans to strengthen the multi-annual budgeting framework. Together with the technical nature of the budgetary targets in the stability programme, this implies that there is currently little short- to medium-term guidance on public spending. Concerning spending control, some overruns were evident for the "voted" (or day-to-day) spending category in 2001 (by 1.4%). As recommended by the 2001 BEPGs, a re-introduction of spending norms, in a medium-term setting aimed at sustaining fiscal consolidation, and an improvement of spending control would be desirable.

5. Whilst Ireland has taken measures to increase competition in some markets and published draft legislation for strengthening competition policy during the last year, there remains an insufficient degree of competition in some sectors of the economy, in particular the network industries; State-owned incumbents continue to have large market shares and further policy measures are required if there is to be more competition from new entrants. The Competition Authority and the OECD have also identified several service sectors where competition could be stronger, such as retailing and professional services.

7.3 Public finances

- **Overall assessment**

6. After an early and rapid fiscal consolidation process, budgetary policy in Ireland in recent years has improved the quality of public finances through, *inter alia*, direct tax relief and a focus on capital expenditure. The 2002 budget continues along these lines, but on a much smaller scale than the previous budget. Based on the targets in the updated stability programme, the 2002 budget is estimated to be broadly neutral. The implementation of the National Development Plan is proceeding, assisted by significantly increased capital spending allocations. The most recent budgets have provided for significant growth rates in discretionary spending. However, a satisfactory framework to guide fiscal planning in the medium term is still lacking. Overall, good progress is being made in implementing the 2001 BEPGs on budgetary policy, with the exception of the guideline on expenditure norms and control.

7. Good progress was made in implementing the 2001 public finance recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendations in the 2001 BEPGs	*Degree of implementation*
➢ Use countervailing budgetary measures during the current fiscal year to better align the budget plans for 2001 with the 2000 BEPGs.	2
➢ Prepare a budget for 2002 that contributes to an orderly easing of the pace of demand.	In progress
➢ Improve expenditure control, applying from 2002 clear norms on spending aggregates.	No new measures
➢ Continue to accord high priority to the National Development Plan especially to infrastructure, human capital investment and R&D, but subject to the fulfilment of the stability objectives of fiscal policy.	In progress

8. The 2000 BEPGs had urged the Irish authorities to "be ready, already in 2000, to use budgetary policy to ensure economic stability" and to gear the budget for 2001 to this objective. The Commission and Council deemed the 2001 budget inconsistent with the BEPGs on account of its expansionary and pro-cyclical nature. In its Recommendation of 12 February 2001, the Council urged the Irish authorities to use countervailing budgetary measures. This was repeated in the 2001 BEPGs. On 6 November 2001, the Council endorsed a Commission report on economic and budgetary developments in Ireland, which concluded that the implementation of the budget for 2001, although marked by a severe tax revenue shortfall, reflected some of the concerns underlying the Recommendation. The Council concluded that, above all, unexpected adverse economic developments were such that the inconsistency with the BEPGs had lost part of its force. The Council further stressed the need for continued vigilance on the fiscal stance given the experience of overheating and in particular advocated a broadly neutral budget for 2002, complementing its advice in the 2001 BEPGs.

9. The budget for 2002 provides for direct tax relief for households and companies, the stimulating impact of which is broadly offset by indirect tax increases and an advancement of the date of payment of corporation tax. On the expenditure side, it targets a 13.4% rise in voted spending[2]. After 4.5% in 2000 and 1.7% in 2001, the general government balance is projected to fall further to 0.7% of GDP[3]. Based on the targets in the updated stability programme 2002-2004, the evolution of the cyclically-adjusted balance, while subject to a considerable degree of uncertainty in Ireland, points to a broadly neutral fiscal stance in 2002, in line with the Council's recommendations. However, the as yet unknown outcome of the benchmarking process (which is to make recommendations on appropriate rates of pay in the public service having regard to private sector norms and conditions and will impact on expenditure retrospectively from December 2001) constitutes a downward risk to the targeted outcome. At the same time, unbudgeted proceeds from the allocation of UMTS licences and a seemingly cautious estimate of (indirect) tax receipts could generate surprises on the upside.

10. Rising 22.9% compared to a target of 21.2%, voted spending overran the target by 1.4% in 2001. Multi-annual projections in the budget for 2002 show a declining growth rate of voted spending, to 13.4% in 2002 to 7.8% in 2004[4]. These significant increases are motivated by a desire to address infrastructural deficiencies and improve public services. However, if unmatched by action on the revenue side, these rates are unsustainable. Against the background of double-digit growth in nominal GDP and tax revenues, the government decided in 2000 not to keep to its self-imposed ceiling of a 4% nominal growth rate for net current expenditure (to hold on average over the government's lifetime), without announcing a target. Previous plans to develop the current system of three-year projections on a no-policy change basis by spending department into a full-fledged multi-annual budgeting system were shelved in the course of 2000. While the seven-year National Development Plan and the three-year tripartite national agreement provide some medium-term guidance to elements of public finance, the (re-)establishment of clear and binding spending norms would constitute an important improvement in the way in which medium-term fiscal planning is implemented. No plans have been announced to improve expenditure control or to apply spending norms.

11. Voted capital spending, which rose by over 25% in both 2000 and 2001, is budgeted to increase by 12.7% in 2002[5]. Such rates of increase bear witness to the high priority given to the National Development Plan 2000-2006 in successive budgets[6]. In the first three years (2000-02), over €10 bn will have been invested in Economic and Social Infrastructure under the plan. However, the resultant level of output has been eroded

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2 "Voted" spending is subject to annual approval by Parliament and represented 84% of total Exchequer expenditure in 2001. Not included in voted spending are, *inter alia*, the service of the national debt, the contribution to the EU budget and the 1% of GNP annual contribution to the National Pensions Reserve Fund.

3 The 2002 target in the updated stability programme of 0.7% of GDP includes a one-off transfer from the Central Bank of 0.5% of GDP which is unlikely to count as an improvement of the budget balance. The quoted outturn for 2001 is an upward revision of the provisional outturn of 1.4% in the stability programme.

4 The projections for voted spending in 2003-2004 are based on technical provisions for future budgets (and do not include the large contingency provisions included in the budgetary targets for these years).

5 Based on technical provisions, voted capital expenditure is scheduled to rise by 8.8% in 2003 and 8.4% in 2004.

6 Apart from Exchequer allocations, other domestic (public and private) and EU funds contribute to the financing of the National Development Plan.

somewhat by the level of inflation in a capacity-constrained construction sector. Although average hourly earnings in construction continue to show annual rises in double-digits (data until Q3-2001), construction inflation is expected to moderate going forward. As before, there is a strong case for carefully prioritising projects.

Table 7.2: **Trends in public finances in Ireland** 1)

	1994	**1996**	**1998**	**1999**	**2000**	**2001**
Government balance	-2.0	-0.2	2.3	2.3	4.5	1.7*
- Total revenue	42.3	39.4	37.5	37.2	36.5	34.6
Tax burden 3)	36.0	33.5	32.3	32.2	32.0	30.3
- Total expenditure	44.3	39.6	35.2	34.8	32.0	32.1
Primary current expenditure	33.4	30.7	27.4	25.8	24.3	24.5
Interest payments	6.1	4.6	3.4	2.4	2.1	1.8
Investment	2.3	2.4	2.7	3.1	3.8	4.2
Primary balance	4.1	4.4	5.7	4.7	6.6	4.3
Government debt	92.6	74.2	54.8	49.3	38.6	34.4
Cyclically-adjusted balance	0.3	0.8	2.1	1.2	2.3	0.5
Cyclically-adj. primary balance	6.4	5.4	5.5	3.5	4.4	2.3

Notes: For footnotes and sources see Table 1.2 for Belgium. Proceeds relative to UMTS licences are expected to affect the government balance in 2002.

7.4 Economic reforms

7.4.1 Labour markets

- **Overall assessment**

12. Despite the economic slowdown, employment growth held up relatively well until the end of 2001. Unemployment at end-2001 has risen slightly but remains at a historically low rate of just over 4%. While this rate could rise towards 5% in 2002, conditions approaching full employment are expected to continue.

13. Some progress was made in implementing the 2001 labour market recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendations in the 2001 BEPGs	*Degree of implementation*
➢ Promote wage developments that are consistent with the maintenance of price stability.	Partial
➢ Continue to focus measures on increasing the participation of women in the labour market.	In progress

14. The available evidence on earnings indicates that wage growth has exceeded the revised pay terms of the PPF Agreement in 2001. Headline HICP inflation moderated in 2001, partly due to a reversal of one-off factors and to indirect tax cuts, but the underlying rate has remained high, reflecting the strength of domestic inflationary pressures. Given

indirect tax rises in the budget for 2002, a marked reduction in HICP inflation is unlikely to be seen before 2003. There is a risk that this might feed through to wages and counteract the effect of a deterioration in the labour market over the short term.

Table 7.3: **Labour market indicators for Ireland**

	Ireland					EU			USA		
	1990	**1994**	**1999**	**2000**	**2001**	**1994**	**2000**	**2001**	**1994**	**2000**	**2001**
Employment rate (ER) [1)]	52.0	53.0	63.3	65.2	:	59.6	63.2	:	72.0	74.1	:
Female ER [1)]	35.6	40.1	52.0	54.1	:	49.3	54.0	:	65.2	67.9	:
Older workers ER [1)]	37.9	38.8	43.7	45.3	:	35.7	37.7	:	54.4	57.7	:
Employment growth [2)]	4.3	3.1	6.3	4.9	2.3	-0.1	1.7	1.1	2.3	1.9	-0.1
ER full time equivalent	:	49.6	58.6	60.6	:	54.9	57.9	:	:	:	:
Unemployment rate (UR)	13.4	14.3	5.6	4.2	3.9	11.1	8.2	7.8	6.1	4.0	4.8
Long-term UR [1)]	9.8	9.4	2.6	1.6	:	5.2	3.6	:	:	:	:
Youth UR (<25)	19.4	23.0	8.4	6.5	6.2	22.1	16.2	15.5	12.4	9.3	10.6
Nominal wage growth [2)]	4.2	2.5	5.3	8.7	9.5	3.1	3.0	3.3	2.4	5.1	5.3
Real Unit Labour Cost growth [2)]	1.3	-1.8	-3.1	-1.9	0.4	-2.4	-0.1	0.3	-1.1	0.7	1.8
Labour Productivity growth [2)]	3.2	2.6	4.3	6.3	4.1	2.9	1.6	0.5	1.5	2.1	1.0
Tax rate on average wage earners [3)]	:	38.4	32.5	28.9	25.8	44.6	43.6	43.0	31.2	30.8	30.0
Tax rate on low wage earners[3)]	:	:	21.5	18.1	17.3	:	38.6	37.8	:	29.0	27.7
NRR on low income families (married) [4)]	:	64.0	57.0	:	:	72.0	67.0	:	59.0	59.0	:
NRR on low wage earners (single) [4)]	:	45.0	42.0	:	:	71.0	68.0	:	59.0	59.0	:

Note: For footnotes and sources see Table 1.3 for Belgium.

15. Further significant progress on widening the tax bands for dual-income couples is included in the proposed budget for 2002. The National Action Plan on Employment, 2001 (May 2001) envisaged that grant approvals to end 2001 will support over 20,000 childcare places, of which over 8000 will be new places. With the development of the National Childcare Census and Database, it should be possible to evaluate the extent to which on-going initiatives are meeting demand. The increase in child benefit in 2001 and in the budget for 2002, payable for all children irrespective of family income, can contribute to the childcare costs of parents and facilitate the decision of mothers to participate in the labour market. However, the high costs of childcare may counteract the effects of child benefit in terms of the economic incentives for mothers to take up employment. The voluntary development and introduction of family-friendly policies are provided for under the PPF Agreement, including a National Framework Committee to evaluate and assess the implementation of policies.

7.4.2 Product markets and the knowledge-based economy

- **Overall assessment**

16. Ireland has the second highest total trade-to-GDP ratio in the EU and high FDI inflows. Labour productivity per employee was 19% above the EU average in 2001. Ireland's price level was 5% above the EU average in 2000 and has been rising relative to the EU average in recent years, although it is relatively low compared to per capita income. The regulatory burden on business is low. Liberalisation of the network industries is continuing but State-owned incumbents still have high market shares in these sectors. There is also insufficient competition in sectors such as retail distribution and professional services.

17. Ireland's ICT production (as a % of total production) is the highest in the EU, partly due to the presence of a large number of foreign-owned high-tech firms. Internet penetration is above the EU average for households. However, R&D expenditure is below the EU average, particularly public R&D, and the number of patents applied for at the EPO, per million inhabitants, is also below the EU average. The proportion of young people (aged 25-34) with at least upper secondary education, at 67% in 1999, was just below the EU average.

18. Good progress was made in implementing the 2001 product market recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendations in the 2001 BEPGs	*Degree of implementation*
➢ Take measures to introduce more competition into specific market segments; strengthen the application of competition policy economy-wide.	In progress
➢ Continue to implement measures to progress competition and liberalisation of transport, electricity and gas sectors, thereby enabling new entrants to compete with large State-owned incumbents in the network industries.	In progress
➢ Implement the government's plans for a substantial increase in R&D expenditure through programmes to support R&D in SMEs, to promote co-operative networks within industry and to develop the national and regional research infrastructure.	2

19. The Irish Government has taken measures to increase competition in some markets. For example restrictions on the number of taxi licences have been removed resulting in a doubling in the number of taxi licences in Dublin and some restrictions on liquor licences and pharmacies have been removed. In other areas, such as off-licences and professional services, proposals are being drafted or reviews are being carried out on restrictions to competition. The Government published a new Competition Bill in December 2001. The proposals included increasing prison terms for serious offences such as price fixing, giving the Competition Authority responsibility for deciding upon mergers (except media mergers) and empowering the Authority to apply EU competition law.

20. The authorities have continued to implement measures to enhance competition in the transport, electricity and gas sectors. In the electricity sector, legislation enacted in 2001 provided for the full liberalisation of the electricity market in 2005. The latest auction of electricity supply (VIPP) contracts attracted a fourth independent supplier. In the gas sector proposals were published in July 2001 for an integrated energy regulator and for an increase in market opening to 82%. As regards transport, in December 2000 a licensing round was launched with the aim of encouraging private operators to provide additional bus services in the Greater Dublin Area (GDA) and an initial set of licences has now been issued. Proposals are being developed to split the incumbent transport company (CIÉ) into three independent companies responsible for buses in Dublin, buses outside Dublin and railways. However, the market share of new entrants remains low as the reforms are not yet complete and will take time to work through. For example in the electricity generation market the State-owned incumbent had a market share of 96%, among the highest in the EU in 1999/2000.

Table 7.4: **Product market indicators for Ireland**

	IRELAND				**EU 15**			
	1998	1999	2000	2001	1998	1999	2000	2001
Labour productivity[1]	110.3	112.4	116.5	119.0	100	100	100	100
Relative price levels[2]	99.0	103.0	105.0		100	100	100	
Total trade to GDP ratio (%)[3]	62.1	62.2	66.8	64.2	41.2	41.9	46.7	45.8
FDI share[4]	4.6	13.6	11.7		2.7	5.0	8.9	
Cross-border M&A share[5]	2.8(0.8)	2.2(1.0)	3.0(1.2)		100	100	100	
Single Market Directives[6]	5.8	4.4	3.6	2.4	3.9	3.6	3.0	2.0
Value of tenders in the O.J.[7]	1.9	2.0	2.6		1.8	1.8	2.4	
Sectoral and ad hoc State aids[8]	0.5	0.6			1.0	0.9		
Prices in telecommunications[9]								
- Local	0.58	0.49	0.51	0.51	0.41	0.41	0.41	0.41
- National	2.04	1.27	0.94	0.94	2.16	1.69	1.34	1.15
- Call to USA	3.68	2.92	2.92	1.91	5.07	4.09	3.39	2.65
Market share fixed telecom (%)[10]								
- Local		100.0	95.0					
- Long Distance		98.7	64.0					
- International		99.0	76.0					
Electricity prices[11]								
- Households	7.98	7.95	7.95	7.95	10.57	10.48	10.40	10.33
- Industry users	6.64	6.62	6.62	6.62	6.44	6.32	6.44	6.33
Market share electricity (%)[12]		96.6						
Education expenditure[7]	5.3	5.0	4.8		5.0	5.0	5.1	
New S&T graduates[13]	22.4							
R&D expenditure[7]	1.39 (1997)				1.87	1.92	1.90	
Internet access at home[14]	6.0	35.5	46.2			12.0	28.4	36.1
Patent applications[15]	55.2	69.9	87.6		129.9	140.9	152.7	

Note: For footnotes and source see Table 1.4 for Belgium.

21. The Irish Government has allocated a total of €1.5bn (1.5% of 2000 GDP) for Research, Technological Development and Innovation (RTDI) under the National Development Plan 2000-06. Measures to support R&D in firms include the R&D Capability Scheme which provides assistance for large-scale investment aimed at building up the R&D infrastructure within firms, the Competitive RTDI scheme which supports high-quality,

high-risk R&D projects within firms and the Innovation Management Capability Scheme which provides training in R&D management. Measures to promote co-operative networks within industry include funding for collaborative research proposals and the dissemination of technical advice among firms on a non-discriminatory basis. Measures to improve the national and regional infrastructure include the Technology Foresight Fund which supports world-class basic research in niche areas and the upgrading of the broadband research network in terms of better-quality links to the US and EU and expanding the regional broadband infrastructure.

7.4.3 Capital markets

- **Overall assessment**

22. Structural reform in capital markets and financial services in 2001 was focused in three main areas – regulation of markets and intermediaries, restructuring of the banking system and initiatives to develop the venture capital industry.

23. The two main developments in relation to the regulation of financial markets and intermediaries were further steps in establishing a single regulatory authority and measures to improve corporate governance. Implementing legislation is being prepared to establish the new Irish Financial Services Regulatory Authority (IFSRA), which will be responsible for regulating banking, insurance and credit unions. IFSRA will be established within the new structure of the Central Bank of Ireland while being independently accountable. IFSRA is expected to begin to operate early in 2002. Corporate governance should be improved by the establishment of an Office of the Director of Corporate Enforcement (on 27 November 2001) under the Company Law Enforcement Act, 2001. The Office will employ administrative, professional and police staff with the objective to enforce compliance with the provisions of Irish company law. A further improvement in corporate governance is expected from a strengthening in the regulation of the accounting and auditing profession. Self regulation by accountancy bodies will continue but will be subject to an overall supervisory framework that will have significant input from users of financial statements and regulators. The new framework will be overseen by an Irish Auditing and Accounting Supervisory Authority (IAASA).

24. Restructuring of the banking system has continued with the sale of the state-owned ICC Bank plc and the TSB Bank to the private sector. Procedures for the sale of the remaining state-owned bank, ACC Bank plc, are nearing completion. The Minister for Finance has accepted an offer for ACC Bank subject to the approval of Parliament. The sale of the bank (to Rabobank Nederland) should be completed in the first quarter of 2002.

25. Some progress was made in implementing the 2001 capital market recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendation in the 2001 BEPGs	*Degree of implementation*
➢ Further develop the risk capital market, particularly with a view to continuing to improve access to start-up and early-stage financing.	In progress

26. In order to develop the venture capital industry, a government-sponsored Seed and Venture Capital Fund Scheme is to be established with the particular objective of improving SME access to finance. The scheme will focus on the provision of relatively small amounts of seed and early-stage capital to SMEs which have a greater regional perspective and are in sectors that are difficult to finance. The investment commitment to the Fund will typically be in the range 30-50% but will never exceed 50%.

8. ITALY

8.1 Macroeconomic context

1. The current economic slowdown is the result of weakened exports and contracting private investment expenditure. Despite ongoing job creation, private consumption suffered from an adverse confidence shock and low real wage increases due to inflationary shocks. Short-term indicators point to a further weakening of economic activity in the last quarter of 2001, both in the manufacturing and the service sectors. Economic activity is forecast to recover in the second half of 2002, driven by the assumed upturn in the global environment. Altogether, GDP growth is expected to average 1.3% in 2002, down from 1.8% in 2001. Employment growth, although slowing in the course of the year, has not lost momentum compared to 2000, recording a 2.1% increase. The unemployment rate continued to decline, averaging 9.5% in 2001, more than a full percentage point below the previous year's level. Due to the oil and food price shocks at the beginning of the year, HICP inflation for 2001 ended at 2.7%, slightly higher than in 2000. Inflationary pressures started to decline in the second half of 2001 and are forecast to continue declining in 2002 subject to ongoing wage moderation and no further energy price hikes.

Table 8.1: **Economic developments in Italy**[1)]

	1992-97	1998	1999	2000	2001
Real GDP	1.3	1.8	1.6	2.9	1.8
Domestic demand	0.5	3.1	3.0	2.3	1.7
Private consumption	1.0	3.1	2.3	2.9	1.6
GFCF (Investment)	-0.2	4.3	4.6	6.1	1.6
Exports (G&S)	7.6	3.6	0.0	10.2	3.8
Imports (G&S)	3.7	9.0	5.1	8.3	3.8
Inflation [2)]	4.1	2.0	1.7	2.6	2.7*
Compensation/employee	4.6	-1.5	2.4	2.9	3.2

Note: For footnotes and sources see Table 1.1 for Belgium.

8.2 Key challenges

2. Whereas Italy made progress in implementing the recommendations of the 2001 BEPGs, a number of key policy issues require continued attention, in particular the control and quality of government expenditure, the wide regional unemployment disparities, the slow transition to the knowledge-based economy, the business environment and competition in the energy and service sector.

Key economic policy challenges for Italy

- Improving the control and quality of government expenditure (addressing the high share of current spending pre-empted by the delivery of pension benefits) and reducing the still high government debt-to-GDP ratio.
- Tackling the persistent wide regional unemployment disparities; the need to rebalance restrictive employment protection legislation; an underdeveloped unemployment safety net; and increasing the low employment rates, particularly for women and older workers.
- Accelerating the hitherto slow transition to the knowledge-based economy in terms of educational attainment, skilled human resources, and R&D and innovation performance.
- Continue improving the business environment and enhancing competition in the energy and service sectors.

3. Italy's fiscal strategy aims to achieve a rapid convergence of actual balances towards zero by 2003. In 2002 and 2003 the adjustment effort relies heavily on the effects of the large one-off measures, in particular the sale of publicly-owned real assets. In the coming years, Italy faces the challenge of simultaneously securing additional and lasting reductions in the primary expenditure to GDP ratio, improving the quality of expenditure, reducing the tax burden and respecting the overall budgetary commitments. Particular attention should be paid to the evolution of healthcare expenditure, which has systematically overshot expectations in the last few years, and to the consequences of fiscal decentralisation. Although the reforms of the pension system of the 1990s have helped contain the growth of ageing-related expenditures as a percentage of GDP and recent projections suggest that the budget can absorb such pressures without imbalances, this depends crucially on Italy's ability to maintain large primary surpluses over the long term and to significantly increase labour force participation rates. Moreover, ageing-related expenditures will still absorb a very high share of current spending in future years. All this highlights the need to hasten the implementation of the pension and labour market reforms and to accelerate the reduction of the high debt ratio in order to provide in advance for competing claims on public resources. Any slowdown in the process of debt reduction would be a cause for concern.

4. The regional segmentation of the Italian labour market remains one of the major sources of inefficiency in Italy. There are persistent regional unemployment disparities (the unemployment rate is still at 19% in the South, compared to only 3.8% in the North and 7% in the Centre) and low labour mobility, and the current wage bargaining mechanism makes insufficient allowance for productivity differences at regional and firm level. The unemployment benefit system continues to be the rather fragmented and also less developed in comparison with other Member States with respect to coverage and benefit level. Recently, a broad range of labour market reforms has been proposed. Among the key measures are the liberalisation of private employment services and more competition with PES, "on-call job" contracts, an additional typology of temporary contracts, and more flexibility in the permanent contracts. It remains to be seen whether and how these proposals will be implemented.

5. Despite the progress made, Italy is still at a very early stage in terms of the development of the knowledge-based economy. Of particular concern are the low levels of educational achievements and the low availability of skilled human resources, which contribute to Italy's weak R&D and innovation performance and mixed results in ICT diffusion. Italy is also below the EU average in terms of financial resources devoted to innovation, and co-operation in the area of R&D is also relatively infrequent. Coupled with the large share of SMEs (and especially very small enterprises) in the economy, the low innovation performance is among the determinants of Italy's persistent productive specialisation in traditional industrial sectors.

6. While progress was made during the last decade in reducing red tape and improving the business environment, administrative procedures remain rather costly and time consuming. This contributes to making the Italian business sector relatively less dynamic than that of other Member States, as measured by indicators on net enterprise creation. Liberalisation of the energy sector has continued but has still to be translated in tangible advantages for users in terms of lower prices, which remain among the highest in the EU, and incumbents retain a strong influence over the market. Competition in some service sectors is being introduced relatively slowly, notably in the areas of professional services, retail distribution and local public services, where a system of competitive auctions has been introduced but with relatively long transition periods.

8.3 Public finances

- **Overall assessment**

7. The Finance bill for 2001 targeted a general government deficit of 0.8% of GDP with projected real GDP growth of 2.9%. Sluggish economic growth, higher disbursements, especially for healthcare, and a shortfall in tax receipts in the first half of the year led to concerns that the outcome for the deficit could fall significantly short of the objective. Thanks also to sustained receipts emerging in the context of the annual tax self-assessment, windfall gains from the tax on the re-evaluation of business companies' real estate assets, an acceleration in the sale of publicly-owned real estate and a rigorous implementation of the budget, official projections now point to a deficit of 1.1% of GDP in 2001, despite real GDP growth averaging one percentage point less than originally projected. The estimated reduction in the debt/GDP ratio is significantly smaller than initially planned, reflecting also a slowdown in the privatisation process and substantial financial transactions.

8. Some progress was made in implementing the 2001 public finance recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendations in the 2001 BEPGs	*Degree of implementation*
➢ Achieve a budgetary deficit of 0.8% of GDP targeted for 2001 in the 2000 update of the stability programme; ensure when preparing the budget for 2002 the respect of the steady path of deficit reduction so to reach the medium-term balanced budget objective in 2003, by securing the high projected primary surpluses.	2
➢ Match any loss of revenue from additional tax and social security contributions with offsetting expenditure cuts; in the formulation of the budget for 2002 ensure a more comprehensive rationalisation of public spending, so as to improve the supply-side conditions of the economy.	In progress
➢ Strengthen the domestic stability pact, translating in a more rigorous way its provisions for the decentralised administration; ensure already in 2001 a more effective control of current primary expenditure, in particular on healthcare.	In progress
➢ Improve the budgetary targets and accelerate the reduction of the high debt ratio, also so as to prepare for long-term budgetary challenges from population ageing; proceed as scheduled to the reassessment of the parameters of the pension system in 2001, including taking further steps to promote the expansion of supplementary privately-funded pension schemes.	Partial

9. The deficit target of 0.8% of GDP had been established assuming GDP growth of 2.9%, while actual growth came closer to 1.8-1.9%. Though falling slightly short of the target, a budgetary outcome of 1.1-1.2% of GDP would still represent a marked reduction of the deficit, realised in a significantly deteriorating growth environment. In preparing the budget for 2002, the government has confirmed the intention to follow the steady path of deficit reduction to achieve the balanced budget in 2003. This result is to be reached also thanks to substantial one-off operations, in particular the sale of publicly-owned real assets. The recourse to one-off operations in order to achieve the budgetary objectives can be defended in the light of the weaker economic circumstances in 2001 and 2002, but they will need to be replaced in the future by measures of a more permanent nature.

10. The tax cuts in 2001 and in the budget for 2002 (abolition of a number of small taxes, including the estate tax, and further social security contributions reductions) entail marginal revenue losses which are expected to be largely compensated by higher tax receipts accruing from the law encouraging the surfacing of the underground economy. The future tax and social security reforms should be implemented so as to respect the principle of matching tax cuts with offsetting expenditure cuts. The budget for 2002 continues to pursue a rationalisation of public expenditure, including through the centralisation of purchases of goods and services. Ample room for further progress still exists.

11. The “domestic stability pact” defines budgetary targets for the decentralised administrations, with an aim to involve all levels of government in the effort of

respecting the Stability and Growth Pact commitments.[7] The deficit of the decentralised administrations is defined on a cash basis and excludes, among other items, capital expenditures, interest payments, healthcare expenditure and central government transfers. The pact has been strengthened in the course of 2001 by introducing expenditure ceilings for regions, provinces and municipalities, and provisions in case of non-compliance for provinces and municipalities. As the ceilings refer to past expenditure commitments, which are not disclosed, it is difficult to assess how binding they are. In 2001 an agreement was concluded between the central government and the regions and new legislation was adopted on healthcare expenditure, establishing an increase in the ceiling to transfers from the government to the regions in 2001 and new ceilings for 2002-2004, and confirming the principle that any deficits are to be covered by the regions, through own resources or by expenditure cuts. The effectiveness of the new arrangements hinges on the credibility that any overruns will not be bailed-out by the central government. In 2002 five regions have increased the so-called "addizionale IRPEF", the regional top-up of the income tax rate.

12. The scheduled reassessment of the parameters of the pension system did not take place. A technical commission (Commissione Brambilla) assessed the effects of the reforms of the pension system, issuing in September a report which underlines a series of "critical aspects" of the present system. At the end of the year the new government submitted to Parliament an enabling act containing the mainstays of its proposed reform of the social security system. The enabling act, which also addresses the issue of further promoting the expansion of supplementary privately-funded pension schemes, is currently the object of discussion between the social partners and is still subject to amendments.

Table 8.2: **Trends in public finances in Italy [1)]**

	1994	**1996**	**1998**	**1999**	**2000**	**2001**
Government balance [2)]	-9.3	-7.1	-2.8	-1.8	-0.3	-1.2
- Total revenue	45.3	46.1	46.8	47.1	46.1	46.3
Tax burden [3)]	40.8	42.8	43.2	43.3	42.7	42.7
- Total expenditure	54.6	53.2	49.6	48.9	46.5	47.5
Primary current expenditure	39.3	37.1	39.4	38.9	38.2	37.6
Interest payments	11.4	11.5	8.0	6.7	6.5	6.2
Investment	2.3	2.2	2.4	2.5	2.4	2.3
Primary balance [2)]	2.1	4.4	5.2	5.0	6.1	5.0
Government debt	123.9	122.1	116.4	114.6	110.5	108.2
Cyclically-adjusted balance [4)]	-8.7	-6.8	-2.6	-1.5	-1.7	-1.2
Cyclically-adj. primary balance [4)]	2.7	4.7	5.4	5.3	4.8	5.0

Note: For footnotes and sources see Table 1.2 for Belgium

7 The domestic stability pact consists of the provisions introduced with the law accompanying the Financial law for 1999 (n. 448/1998), subsequently modified every year (in particular in 2000 to exclude healthcare expenditure from the definition of the reference deficit).

8.4 Economic reforms

8.4.1 Labour markets

- **Overall assessment**

13. The labour market performance continued to improve in 2001, with faster employment growth, continued greater use of new and more flexible contracts, and on-going wage moderation in the private sector. Despite recent improvements, employment rates remain significantly lower in the Mezzogiorno than in the Centre-North. Italy also recorded high rates of long-term and youth unemployment, as well as low employment rates, in particular for women and older workers.

14. Some progress was made in implementing the 2001 labour market recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendations in the 2001 BEPGs	*Degree of implementation*
➢ Reinforce efforts to let wage developments better take into account productivity and local labour market conditions.	Partial
➢ Continue to increase labour market flexibility by combining measures to improve social protection of the unemployed with an easing of job protection for employees on permanent contracts.	Partial
➢ Continue to bring down the tax burden on labour by gradually reducing tax and social security contributions. In particular, the reduction of the tax wedge on labour costs should be particularly targeted at the lowest end of the wage scale as a follow-up to recent measures, thereby increasing the employment opportunities for low-skilled workers, while reducing the budgetary impact of the tax cuts and complying with the need for continued progress in public debt reduction.	In progress

15. The Italian authorities' attitude towards greater wage differentiation has changed. Indeed, it is now widely acknowledged that greater wage differentiation is needed to achieve a significant reduction in the unemployment rate in the South. The government is proposing a more decentralised wage-bargaining system, while stressing that this issue is mainly in the domain of the social partners.

16. The envisaged general reform of employment incentives and unemployment benefits has not yet been implemented. Both the easing of job protection regulations and a new overall reform of "social shock absorbers" (ammortizzatori sociali) along the lines of a welfare-to work policy are included in the recent "Legge Delega", which should be approved by February-March 2002.

17. Further tax cuts on labour were implemented in 2001. The planned overall reform of the tax system has been postponed to 2003 due to the budgetary impact of the recent slowdown. The government should receive legislative power on this matter from the Parliament. The reform will lead to a system with only two tax rates on personal income (23% for incomes below €103,250, and 33% for higher incomes) and will reduce the overall fiscal pressure. As an initial measure, in order to reduce the tax wedge on labour,

the enabling act on pension (legge delega) is proposing to reduce social security contributions for new employees by 3 to 5 percentage points. The financial feasibility of this reduction remains to be seen.

Table 8.3: **Labour market indicators for Italy**

	Italy					EU			USA		
	1990	**1994**	**1999**	**2000**	**2001**	**1994**	**2000**	**2001**	**1994**	**2000**	**2001**
Employment rate (ER) 1)	:	51.2	52.6	53.7	:	59.6	63.2	:	72.0	74.1	:
Female ER 1)	:	35.4	38.3	39.6	:	49.3	54.0	:	65.2	67.9	:
Older workers ER 1)	:	29.3	27.6	27.7	:	35.7	37.7	:	54.4	57.7	:
Employment growth 2)	1.6	-1.5	1.1	1.6	1.5	-0.1	1.7	1.1	2.3	1.9	-0.1
ER full time equivalent	:	49.9	51.0	51.7	:	54.9	57.9	:	:	:	:
Unemployment rate (UR)	9.0	11.1	11.3	10.5	9.5	11.1	8.2	7.8	6.1	4.0	4.8
Long-term UR 1)	:	6.7	6.9	6.4	:	5.2	3.6	:	:	:	:
Youth UR (<25)	27.2	32.3	32.6	30.7	27.9	22.1	16.2	15.5	12.4	9.3	10.6
Nominal wage growth 2)	10.4	3.0	2.4	2.9	3.2	3.1	3.0	3.3	2.4	5.1	5.3
Real Unit Labour Cost growth 2)	1.0	-3.5	0.0	-0.7	0.3	-2.4	-0.1	0.3	-1.1	0.7	1.8
Labour Productivity growth 2)	1.0	3.2	0.8	1.4	0.3	2.9	1.6	0.5	1.5	2.1	1.0
Tax rate on average wage earners 3)	:	49.9	47.2	46.7	46.2	44.6	43.6	43.0	31.2	30.8	30.0
Tax rate on low wage earners 3)	:	:	44.1	43.3	42.9	:	38.6	37.8	:	29.0	27.7
NRR on low income families (married) 4)	:	47.0	53.0	:	:	72.0	67.0	:	59.0	59.0	:
NRR on low wage earners (single) 4)	:	35.0	39.0	:	:	71.0	68.0	:	59.0	59.0	:

Note: For footnotes and sources see Table 1.3 for Belgium.

8.4.2 Product markets and the knowledge-based economy

- **Overall assessment**

18. The Italian economy is less open (as measured by the total trade-to-GDP ratio) than other EU economies of similar size. Labour productivity is above the EU average but it has slightly decreased recently in relative terms. At 1,7%, the transposition deficit of Internal Market directives is only slightly above the EU target, while the number of infringement cases for violation of Internal Market rules is among the highest in the EU. State aids have decreased and their composition has improved. Efforts to improve the business environment have started to bear fruit, but administrative procedures remain relatively complex. Competition in the service sector is taking hold particularly slowly. Recent measures should contribute to increasing competition in the energy sector, where incumbents retain a very strong market position and prices remain among the highest in the EU.

19. The relatively low levels of the population's educational achievement, possibly related to below EU-average public investments in education as a share of GDP, may constrain Italy's transition to the knowledge-based society. Italy is also below the EU average in terms of financial resources devoted to innovation, as indicated by the low GDP shares of public and particularly business R&D investment. Co-operation in the area of R&D

and innovation is also relatively infrequent. ICT use has picked up rapidly, but the overall diffusion is mixed. In particular, the number of families and pupils connected to the internet is still lower than the EU average, as is the development of e-commerce.

20. Some progress was made in implementing the 2001 product markets recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendations in the 2001 BEPGs	*Degree of implementation*
➢ Promote business sector involvement in R&D and further encourage the wider diffusion of ICT and the use of e-commerce.	In progress
➢ Ensure that liberalisation in the energy sector will lower prices for households and small business users who are still unable to choose their provider; ensure the competitive provision of utilities at the local level in the framework of the reform of local public services	In progress
➢ Reduce further the administrative burden for businesses and continue efforts to streamline regulations and administrative procedures	In progress
➢ Increase competition and remove access restrictions in the area of professional services	No new measures

21. The “100 days” provisions enacted by the new government include a number of measures to promote R&D and innovation. Researchers in universities and public research centres will be allowed to obtain intellectual property rights protection for their discoveries. Companies will also have the possibility to replace capital through an insurance policy, which should be particularly relevant for new innovative businesses, which typically have few physical assets to provide as collateral. The “Tremonti Law II” tax measures, encouraging new investment in physical and human capital, should also contribute to strengthening the business innovation potential. To bring education closer to the needs of science and industry, in 2001 the Ministry for education was merged with the Ministry for University and Scientific Research. An Information Society action plan was launched in 2000 after the e-Europe initiative, with particular emphasis on the use of ICT in education and business. The use of ICT is also being promoted within the public administration and in its relations with businesses and citizens. A new Ministry for Technological Innovation was established in 2001 to follow up and co-ordinate the various initiatives in the field of information society. Fiscal incentives were also approved to promote the use of e-commerce.

22. Steps were taken to further liberalise the energy sector, notably the simplification of the requirements to set up new supply capacity and the clarification of rules on third party access to infrastructure. The sale of the electricity incumbent’s ENEL generation capacity is proceeding which, according to a decree issued in early 2002, should bring the incumbent’s share of total national generation capacity below 50% by October 2002. Once the sale of the incumbent’s earmarked assets is completed, the threshold for customers eligible to choose supplier will be reduced to 0.1 GWh. Thanks to a new connection with Greece, interconnection capacity will be increased. The electricity exchange market should be established in early 2002 but on the other hand there is still no clear timetable for the establishment of the Single Buyer, whose role is to purchase electricity on behalf of captive (i.e. low voltage) users and thus guarantee lower prices for final users. In the gas market, a first initial public offer of the equity of the gas

transmission company SNAM Rete Gas took place in late 2001. Contrary to the electricity market, where the incumbent ENEL is selling some generation plants to reduce its market position, no similar measures have been taken with respect to the gas incumbent ENI. The authorities believe that the simplification of the rules on new capacity and improved access to infrastructure should be sufficient to encourage new entries and ensure compliance with the ceilings set on the maximum supply allowed by any single operator (75% by 2003). The reform of local public services (including local utilities) has recently been completed whereby, subject to sectoral rules, the management of the infrastructure is to be separated from the provision of services, with the latter being attributed through competitive auctions. The transition period to adopt the new regime may, in some cases, be relatively long (up to 7 years).

23. Efforts started in the early 1990s to reduce red tape and tackle inefficiencies in the public administration continued during 2001. The review and consolidation of existing regulation is being pursued, and Regulatory Impact Assessment instruments are being employed to evaluate the overall impact of new rules. Ties are established with the business community to foster the transfer of relevant experiences to the public sector. By early 2001 the network of one-stop-shops was serving 70% of the population and was being further expanded with the goal of covering 90% of the population. The time and costs of setting up a new business have fallen markedly, but remain relatively cumbersome compared to the EU average.

24. The Government has expressed its commitment to gradually introduce competition and has set out the main principles of the reform, but so far no concrete measures have been proposed.

Table 8.4: **Product market indicators for Italy**

	ITALY				EU 15			
	1998	1999	2000	2001	1998	1999	2000	2001
Labour productivity[1]	114.9	115.2	113.9	113.4	100	100	100	100
Relative price levels[2]	88.0	86.0	86.0		100	100	100	
Total trade to GDP ratio (%)[3]	19.4	19.3	22.0	22.0	21.7	21.8	24.8	24.7
FDI share[4]	0.2	0.3	1.0		2.7	5.0	8.9	
Cross-border M&A share[5]	5.6(14)	5.4(14)	5.5(13.7		100	100	100	
Single Market Directives[6]	5.7	3.9	3.2	1.7	3.9	3.6	3.0	2.0
Value of tenders in the O.J.[7]	1.3	1.6	2.1		1.8	1.8	2.4	
Sectoral and ad hoc State aids[8]	0.9	0.8			1.0	0.9		
Prices in telecommunications[9]								
- Local	0.24	0.24	0.25	0.25	0.41	0.41	0.41	0.41
- National	2.16	1.69	1.72	1.44	2.16	1.69	1.34	1.15
- Call to USA	4.99	3.63	2.79	2.79	5.07	4.09	3.39	2.65
Market share fixed telecom (%)[10]								
- Local		99.8	93.0					
- Long Distance		93.0	76.0					
- International		68.0	60.0					
Electricity prices[11]								
- Households	15.64	15.88	16.13	14.72	10.57	10.48	10.40	10.33
- Industry users	6.63	6.60	7.85	8.33	6.44	6.32	6.44	6.33
Market share electricity (%)[12]		71.0						
Education expenditure[7]	4.6	4.5	4.6	4.5	5.0	5.0	5.1	
New S&T graduates[13]	5.1							
R&D expenditure[7]	0.98	1.04			1.87	1.92	1.90	
Internet access at home[14]	7.0	23.7	32.9			12.0	28.4	36.1
Patent applications[15]	64.4	68.1	72.3		129.9	140.9	152.7	

Note: For footnotes and source see Table 1.4 for Belgium.

8.4.3 Capital markets

- **Overall assessment**

25. Financial market conditions in Italy reflected the global downturn in issuance activity in 2001. However, the STAR segment, set up in April 2001, created opportunities for small and medium quality companies to gain visibility. The Trading After Hours market has also attracted growing volumes, adding more flexibility for investors. The restructuring and consolidation process within the banking sector continued, with 59 per cent of all assets now concentrated in six large banking groups. Unlike the evolution observed in most other European countries, venture capital investments increased slightly in the first half of 2001. However, notwithstanding continuous growth in recent years, the Italian venture capital market remains among the smallest in the EU when measured in terms of national GDP.

26. The Settlement Finality Directive, aimed at reducing systemic risks in payment and securities settlement systems, was transposed into the Italian law in April 2001. The Parliament has approved a decree to stop foreign investors paying withholding tax on BTPs. This should increase the attractiveness of BTPs and contribute to a narrowing of spreads. Tax incentives granted to those who join supplementary pension funds were

increased, which should have a positive impact on the development of private pension funds.

27. Some progress was made in implementing the 2001 capital market recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendation in the 2001 BEPGs	*Degree of implementation*
➢ Develop further the risk capital market by easing constraints on institutional investment in equity capital and adapting the fiscal framework so as to facilitate investment and entrepreneurship, the latter to be also encouraged by adjusting bankruptcy laws	In progress

28. Some of the quantitative constraints on institutional investment were removed. The draft law on bankruptcy and insolvency submitted by the Government in 2000, has not been adopted by the Parliament. A new package is to be proposed by the government in early 2002.

9. LUXEMBOURG

9.1 Macroeconomic context

1. GDP growth was very strong (7.5%) in 2000, even by Luxembourg standards. Signs of deceleration have been observed since the beginning of 2001 but growth remained dynamic in 2001 and significantly stronger than in neighbouring countries, due to continued strong growth in private and public consumption, as well as in gross fixed capital formation. Employment rose by more than 5% a year both in 1999 and in 2000. This strong job creation continued at least in the first three quarters of 2001, but unemployment began to rise slightly in the second part of the year. Inflation decelerated significantly since the beginning of 2001, the annual rise in the HICP slowing down to 2.4% in 2001. This was in large part due to the decrease in oil prices, as underlying inflation continued to accelerate. Wages rose rather fast in recent years, partly due to faster inflation and the indexation clause. They accelerated in the first part of 2001, with total monthly labour cost rising by 5.5% as against 4.9% in 2000.

Table 9.1: **Economic developments in Luxembourg**[1)]

	1992-97	1998	1999	2000	2001
Real GDP	5.6	5.8	6.0	7.5	5.1 *
Domestic demand	3.5	3.1	7.5	2.4	4.5 *
Private consumption	2.1	4.0	2.1	3.1	3.4 *
GFCF (Investment)	3.0	2.8	19.6	-3.0	5.9 *
Exports (G&S)	5.8	12.9	13.3	16.4	8.4 *
Imports (G&S)	3.9	11.5	15.6	13.8	8.6 *
Inflation [2)]	:	1.0	1.0	3.8	2.4 *
Compensation/employee	3.6	2.3	3.4	4.3	5.3 *

Note: For footnotes and sources see Table 1.1 for Belgium.

9.2 Key challenges

2. Whereas Luxembourg made progress in implementing the recommendations of the 2001 BEPGs, a number of key policy issues require continued attention, in particular the still low participation and employment rate, the wage formation process and competition legislation.

Key economic policy challenges for Luxembourg

- Increasing the low national participation and employment rate, especially for older persons.
- Reconsidering the wage formation process, characterised by a full indexation to price developments.
- Accelerating implementation of the reform on competition legislation, including the abolishment of fixed and monitored prices, a unique legislative framework for public procurement, and empowering the competition authority to apply EC law.

3. All national employment rates, including the overall rate, the rates for women and in particular for older workers, lag behind the EU targets. While the growth in female employment has been the main source in contributing to increasing national employment rates, there has been little progress as regards increasing the employment rate of older workers. The efforts in this respect have been limited: there is a proposal to tighten eligibility for the disability pension scheme, while no revisions are envisaged as regards pre-retirement and early retirement schemes.

4. Nominal wage growth has continued to be higher than in the EU on average. This evolution is largely due to the fact that wages are indexed to price developments. Index thresholds were reached in July 2000 and April 2001, leading to wage increases and risking a vicious circle of wages and prices.

5. No progress has been made in terms of legislative reforms to adapt the competition framework. The proposals consist of the abolition of fixed and monitored prices, setting up a single legislative framework for public procurement, and the empowerment of the competition authority to apply EC law. Part of the problem lies in desire of the authorities to assess the price developments following the introduction of the euro before dropping the system fixed and monitored prices. These deficiencies in the competition framework create potential limits to competition.

9.3 Public finances

- **Overall assessment**

6. The general government balance has been in comfortable surplus for years in Luxembourg and, according to most recent data, this surplus rose to a record 6.2% of GDP in 2000 as strong activity boosted government revenues and government expenditure, though increasing fast, rose less than projected. Due also to stronger than expected increase in nominal GDP, the share of government spending in GDP fell to 38.6% as against 42.1% in 1999.

7. According to most recent data, the general government surplus, while remaining substantial, declined to 4.1% of GDP in 2001 and should keep decreasing to 2.8% of GDP in 2002. The movement is expected to be reversed in 2003, to a surplus reaching 3-3½% of GDP. Slower activity and less dynamic employment are expected to result in decelerating tax revenues, especially in 2002. Moreover, a tax reform which entered into force on 1 January 2001 included cuts in the personal income tax in two steps, at the beginning of 2001 and 2002, and was completed by cuts in the corporate tax in 2002, the total ex-ante budgetary cost of these measures being 3.1% of GDP in the two years.

8. However, besides the impact of these tax cuts, the 2.1 percentage points of GDP decline in the government surplus in 2001 was primarily due to a large (1.7 percentage point of GDP) increase in expenditure, from 38.6% of GDP in 2000 to 40.3% in 2001. This rise is mainly to be attributed to fast growing central government spending. Investment by the State rose by half a percentage point of GDP, from 2% of GDP in 2000 to 2.5% of GDP in 2001, and is planned to rise to 3.0% of GDP in 2002. In addition, central government current expenditure rose by 6.2% in 2001 (comparing the level planned in the 2001 budget with the 2000 realisation).

9. Some progress was made in implementing the 2001 public finance recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendations in the 2001 BEPGs	*Degree of implementation*
➢ Tighten budgetary conditions when executing the budget in 2001 and when preparing the budget for 2002 in order to counter inflationary pressures should they persist	Partial
➢ Monitor closely the increase in government expenditure in order to safeguard the balance of public finances should real GDP growth falter as well as their sustainability in the long term taking account of the ageing population.	Partial

10. The first recommendation was fully justified when it was drafted, taking into consideration the strong acceleration in inflation recorded in 2000. However, its relevance has lessened somewhat since then as short-term inflationary risks have abated to a large extent, even if underlying inflation and wage increases are still rather fast.

11. Recent developments in Luxembourg's public finance do not seem to be in full conformity with the second recommendation, which highlighted the necessity for Luxembourg to closely monitor fast growing expenditure, taking into account their high degree of rigidity, which would create a problem in case of a durable slowdown in economic activity in the future. Even if this fast rise in government spending may be partly explained by a rapid increase in investment expenditure, some restraint might still be recommended in a longer term perspective : this fast rising trend is clearly not a concern as long as strong growth in economy and employment generates even faster rising revenues but would create a significant risk should growth significantly slow down in the medium term.

Table 9.2: **Trends in public finances in Luxembourg [1)]**

	1994	**1996**	**1998**	**1999**	**2000**	**2001**
Government balance [2)]	2.9	2.0	3.4	3.6	6.2* (6.1)	4.1*(4.3)
- Total revenue	47.7	47.4	45.5	45.7	44.9*(46.1)	44.4*(43.8)
Tax burden [3)]	41.7	42.6	40.6	41.0	41.5	39.8
- Total expenditure	44.8	45.4	42.1	42.1	38.6*(40.0)	40.3*(39.5)
Primary current expenditure	39.3	39.9	36.7	36.9	35.2	35.0
Interest payments	0.4	0.4	0.4	0.3	0.3	0.3*(0.2)
Investment	4.3	4.7	4.5	4.2	4.1	4.3
Primary balance [2)]	3.3	2.3	3.7	3.9	6.5*(6.3)	4.4*(4.6)
Government debt	5.4	6.2	6.2	5.9	5.3	5.1
Cyclically-adjusted balance [4)]	2.3	3.8	3.2	3.1	4.4	3.0
Cyclically-adj. primary balance [4)]	2.7	4.2	3.5	3.4	4.7	3.3

Note: For footnotes and source see Table 1.2 for Belgium.

9.4 Economic reforms

9.4.1 Labour markets

- **Overall assessment**

12. The unemployment rate remained very low and employment growth continued to be strong in 2001. However, employment growth has mainly benefited cross-border workers and the national employment rate showed only a slight upward trend. The employment rate for older workers in particular remains one of the lowest in the EU.

13. Some progress was made in implementing the 2001 labour market recommendation.

- **Implementation of the 2001 BEPGs**

Country-specific recommendation in the 2001 BEPGs	*Degree of implementation*
➢ Make further efforts to increase the national employment rate, especially for older workers by increasing the incentives in early retirement, pre-retirement and disability pension schemes to remain in employment, and for women by removing obstacles to their remaining in employment or re-entering the labour market.	Partial

14. Luxembourg has made some efforts aimed at restricting access to the disability pension scheme and keeping older workers longer in employment. A bill concerning the revision of the definition of eligibility for a disability pension has been sent to the Parliament. No new measures have been taken regarding early retirement and pre-retirement schemes, whilst the accrual rate of pension rights in the old-age pension scheme have been raised for each additional year worked beyond the age of 55, provided that the number of participation years reaches at least 38 years. Female labour force participation and flexibility in work have been encouraged by a bill concerning voluntary access to part-time work by full-time workers.

Table 9.3: **Labour market indicators for Luxembourg**

	Luxembourg					EU			USA		
	1990	**1994**	**1999**	**2000**	**2001**	**1994**	**2000**	**2001**	**1994**	**2000**	**2001**
Employment rate (ER) 1)	59.5	59.9	61.7	62.8	:	59.6	63.2	:	72.0	74.1	:
Female ER 1)	41.8	44.4	48.6	50.2	:	49.3	54.0	:	65.2	67.9	:
Older workers ER 1)	27.1	23.5	26.4	27.3	:	35.7	37.7	:	54.4	57.7	:
Employment growth 2)	4.2	2.5	5.0	5.6	5.5	-0.1	1.7	1.1	2.3	1.9	-0.1
ER full time equivalent	:	58.0	59.1	60.4	:	54.9	57.9	:	:	:	:
Unemployment rate (UR)	1.7	3.2	2.4	2.4	2.4	11.1	8.2	7.8	6.1	4.0	4.8
Long-term UR 1)	0.5	0.9	0.7	0.5	:	5.2	3.6	:	:	:	:
Youth UR (<25)	3.9	7.3	7.1	7.3	7.3	22.1	16.2	15.5	12.4	9.3	10.6
Nominal wage growth 2)	5.2	4.0	3.5	5.6	4.4	3.1	3.0	3.3	2.4	5.1	5.3
Real Unit Labour Cost growth 2)	3.7	-2.9	0.2	-1.7	2.8	-2.4	-0.1	0.3	-1.1	0.7	1.8
Labour Productivity growth 2)	-1.9	1.6	0.7	3.6	-1.4	2.9	1.6	0.5	1.5	2.1	1.0
Tax rate on average wage earners 3)	:	35.1	34.6	35.5	33.9	44.6	43.6	43.0	31.2	30.8	30.0
Tax rate on low wage earners 3)	:	:	29.5	30.4	28.8	:	38.6	37.8	:	29.0	27.7
NRR on low income families (married) 4)	:	90.0	87.0	:	:	72.0	67.0	:	59.0	59.0	:
NRR on low wage earners (single) 4)	:	85.0	76.0	:	:	71.0	68.0	:	59.0	59.0	:

Note: For footnotes and sources see Table 1.3 for Belgium.

9.4.2 Product markets and the knowledge-based economy

- **Overall assessment**

15. The Luxembourg economy's high openness (as measured by the total trade-to-GDP ratio) stimulates competition on the product markets. As a result, consumer price levels are maintained below the EU average and labour productivity is the highest in the EU. However, over the most recent period, developments in the application of Single Market rules have slowed down and announced reforms within the competition framework are not yet achieved. Network industries are progressively liberalised but the small size of the country makes it very dependent from abroad for a lot of sectors. Although administrative burden is not excessive, time requirements to create a start-up are high.

16. ICT penetration is progressing rapidly, despite the high cost of access to the internet. E-government initiatives and internet access at school are heading upward. Research is high on average but remain low in high-tech industries. The efficiency of the education system casts doubts as Luxembourg displayed the lowest EU score in terms of literacy. Luxembourg's relatively low percentage of 25-34 year-old attaining at least upper secondary education may be a potential problem for a smooth transition to the knowledge-based economy.

17. Limited progress was made in implementing the 2001 product market recommendations.

Table 9.4: **Product market indicators for Luxembourg**

	LUXEMBOURG				EU 15			
	1998	1999	2000	2001	1998	1999	2000	2001
Labour productivity[1]	187.2	196.2	207.0	202.3	100	100	100	100
Relative price levels[2]	101.0	98.0	97.0		100	100	100	
Total trade to GDP ratio (%)[3]	50.2	51.9	52.4		41.2	41.9	46.7	45.8
FDI share (BLEU)[4]	7.0	41.3	87.0		2.7	5.0	8.9	
Cross-border M&A share[5]	1.0(0.2)	1.0(0.2)	0.9(0.2)		100	100	100	
Single Market Directives[6]	6.2	5.7	3.2	2.2	3.9	3.6	3.0	2.0
Value of tenders in the O.J.[7]	2.1	1.9	1.6		1.8	1.8	2.4	
Sectoral and ad hoc State aids[8]	0.9	1.0			1.0	0.9		
Prices in telecommunications[9]								
- Local	0.37	0.37	0.37	0.31	0.41	0.41	0.41	0.41
- National	0.37	0.37	0.37	0.31	2.16	1.69	1.34	1.15
- Call to USA	5.67	2.74	2.06	1.44	5.07	4.09	3.39	2.65
Market share fixed telecom (%)[10]								
- Local		100						
- Long Distance		100						
- International		89.0						
Electricity prices[11]								
- Households	10.63	10.72	10.48	11.38	10.57	10.48	10.40	10.33
- Industry users	7.26	7.30	6.95	6.4	6.44	6.32	6.44	6.33
Market share electricity (%)[12]		13.5						
Education expenditure[7]					5.0	5.0	5.1	
New S&T graduates[13]	1.4		1.8					
R&D expenditure[7]					1.87	1.92	1.90	
Internet access at home[14]		117	36.3	43.6		12.0	28.4	36.1
Patent applications[15]	143.5	200.5	170.3		129.9	140.9	152.7	

Note: For footnotes and source see Table 1.4 for Belgium.

- **Implementation of the 2001 BEPGs**

Country-specific recommendation in the 2001 BEPGs	*Degree of implementation*
➢ Implement the announced reform of the competition legislation and thus the abolition of fixed and monitored prices.	No new measures

18. No progress has been made in 2001 in implementing the reforms to adapt competition law, fixed and monitored prices, and market transparency. The proposals were already introduced in 2000 but no progress has been made so far. The proposals consist of: (a) abolishing fixed and monitored prices, (b) a unique legislative framework which would apply to all sort of public procurement at all levels of authority, and (c) empowering the competition authority to apply EC law. A draft legislation has been prepared on the abolition of fixed prices. The authorities also stressed that the delays are partly explained by the wish not to give the impression that possible prices increases actually due to the introduction of the euro are caused by the liberalisation of prices.

9.4.3 Capital markets

- **Overall assessment**

19. Luxembourg's financial sector is centred on international private banking, investment fund management and insurance, each of these activities being large by international standards and all of them growing rapidly.

20. Laws intended to keep pace with market developments were adopted or are to be adopted, for instance regarding financial collateral arrangements, or e-money. The EU Directive on settlement finality in payment and securities settlement systems was transposed into national law early 2001. As expected last year, a new law on pension funds was adopted to clarify some of the points of the 1999 law (for instance regarding agreement of assets and liabilities managers).

21. To improve transparency and co-operation between supervisory authorities, the list of institutions with which the supervisory authority can exchange information, as well as the list of cases possibly concerned by such an exchange of information, have been extended. In the insurance sector, prudential rules will be clarified.

10. THE NETHERLANDS

10.1 Macroeconomic context

1. The Dutch economy slowed down markedly in 2001, as a result of weaker domestic demand, caused by receding private investment and sluggish private consumption, and the deterioration in external trade. Despite the still strong rise in employment, fast and even accelerating wage increases and important tax cuts implemented on 1st January 2001, private investment receded and private consumption proved surprisingly sluggish. As a result, growth in 2001 was mainly supported by fast rising government consumption and public investment. Labour market conditions remained tense. Strong employment growth in recent years led to an impressive decline in registered unemployment, which fell to levels unseen since the early 1970s and the lowest in the EU. Unemployment did not yet resume rising, despite the slowdown in activity. Consequently, wage increases accelerated significantly since 1997-1998 and continued to rise fast in 2001. Inflation jumped to 4½%-5% since the beginning of 2001, the annual rise in HICP inflation reaching over 5% as a result of mounting tensions on the labour and good markets and a rise in indirect taxation, in particular in the standard VAT rate.

Table 10.1: **Economic developments in the Netherlands**[1)]

	1992-97	1998	1999	2000	2001
Real GDP	2.5	4.3	3.7	3.5	1.5
Domestic demand	2.0	4.8	4.2	3.0	1.3
Private consumption	2.0	4.8	4.5	3.8	1.3
GFCF (Investment)	2.7	4.2	7.8	3.8	-1.3
Exports (G&S)	6.6	7.4	5.4	9.5	2.3
Imports (G&S)	5.9	8.5	6.3	9.4	2.2
Inflation[2)]	1.9	1.8	2.0	2.3	5.2
Compensation/employee	2.6	3.5	3.3	4.6	5.0

Note: For footnotes and sources see Table 1.1 for Belgium.

10.2 Key challenges

2. Whereas the Netherlands made progress in implementing the recommendations of the 2001 BEPGs, a number of key policy issues require continued attention, in particular the labour market participation and the labour productivity growth.

Key economic policy challenges for the Netherlands

- Increasing further labour market participation by drawing currently inactive people into the labour market.
- Tackling the relatively slow labour productivity growth, stemming, *inter alia*, from the rapid employment growth in services; insufficient business investment, particularly in R&D; and a relatively poorly performing high-tech manufacturing sector.

3. Despite robust employment growth, labour market tightness was a major driving force behind strong wage increases in recent years. A further improvement of employment rates will depend on the continued growth of female participation and a stronger activation of older persons and minorities. Moreover, there exists a substantial untapped reserve of labour among benefit claimants. As much as 7% of the labour force receive unemployment benefits or social assistance and 11% receive disability benefits (including partially disabled workers).

4. The combination of relatively high wage increases and a relatively slow productivity growth threatens to reduce the competitiveness of the economy. The slow growth of labour productivity may be attributed, among other things, to the rapid employment growth in services; insufficient business investment, particularly in R&D; and a relatively poor performing high-tech manufacturing sector.

10.3 Public finances

- **Overall assessment**

5. The situation of Dutch public finance improved markedly in recent years: the general government deficit, which still amounted to 4.2% of GDP in 1995 turned into a 0.4% of GDP surplus in 1999, which widened to 2.2% of GDP in 2000 (of which 0.7% of revenues from the auction of UMTS licences). Due to diminishing deficits and strong real as well as nominal GDP growth, the debt ratio, which was fluctuating between 75% and 80% since it had been stabilised at the end of the 1980s, began to decrease significantly in 1997. It fell to 63.1% in 1999 and 57.1% in 2000, declining by 7 percentage points of GDP in one year.

6. A tax reform had been implemented on 1st January 2001, featuring reductions in income tax and social contributions as well as a rise in indirect taxes, the net tax alleviation amounting to about 0.8% of GDP. Subsequently, the government decided additional spending of about 0.6% of GDP in the fields of healthcare, education and security. However, according to the latest available information, the surplus declined to 0.7% of GDP in 2001 and the debt ratio to 51.8% : the decrease in the surplus remained limited as faster than expected increase in prices and wages probably for a part compensated for slower real growth and the slowdown in activity did not yet result in additional spending as unemployment did not rise before the end of the year.

7. Good progress was made in implementing the 2001 public finance recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendations in the 2001 BEPGs	*Degree of implementation*
➢ Maintain strict control of government expenditure despite lower expected economic growth, in order to limit the reduction in the government surplus in 2001 (projected at 0.7% of GDP in the 2000 update of the stability programme) and to contain inflationary pressures.	2
➢ Prepare a budget for 2002, the stance of which is firmly oriented at limiting inflationary pressures, thus improving the budgetary outcome as against 2001. To this end, the budgetary margins as defined in the 2000 update of the stability programme should be allocated taking into consideration cyclical conditions as a matter of priority and ensure a clear improvement in the budgetary position.	Partial
➢ With a view to securing long-term sustainability of public finances taking into account the ageing population, use available budgetary margins for accelerated debt reduction as a matter of priority from 2002.	2

8. According to the latest estimates, the general government surplus should amount to 0.7% of GDP in 2001, which is exactly the projection of the 2000 update of the stability programme.

9. A clear improvement in the budgetary position will probably not be achieved in nominal terms in 2002 due to significantly weaker-than-forecast GDP growth. However, according to Commission services' computations, under the current growth forecasts, a decline in the actual surplus from 0.7% of GDP in 2001 to 0.4% in 2002, as expected by the "Centraal Planbureau", would correspond in cyclically-adjusted terms to an increase from 0.1% of GDP in 2001 to about 0.6%-0.7% in 2002. 6. The 2002 budget projects that the general government surplus should amount to 1.0% of GDP in 2002 (which was, at that moment, also the estimated surplus for 2001). However, the budget was based on forecasts performed before September 11, which projected GDP growth at 2% both in 2001 and 2002. Since then, the official forecasts were revised twice downwards, the latest growth projection being 1% for 2001 and 1¼% for 2002, while the surplus is now estimated at 0.4% of GDP in 2002. The budget foresees additional spending amounting to 0.7% of GDP in the same domains

10. The share of tax windfalls recorded in previous years, which has been translated into new tax cuts in the 2002 budget is significantly smaller (and the one allocated to the debt reduction sizeably larger) than if the 50/50 formula decided in the 1998 coalition agreement had been followed.

Table 10.2: **Trends in public finances in the Netherlands** [1)]

	1994	1996	1998	1999	2000	2001
Government balance [2)]	-3.6	-1.8	-0.8	0.4	2.2	0.7* (1.3)
- Total revenue	50.0	47.8	46.4	47.5	47.5	45.9
Tax burden [3)]	43.0	40.8	40.3	41.7	41.6	40.3
- Total expenditure	53.6	49.6	47.2	47.1	45.4	44.5
Primary current expenditure	43.9	40.3	38.6	38.4	37.8	37.5
Interest payments	5.8	5.6	4.8	4.5	3.9	3.3
Investment	2.9	3.1	2.9	3.0	3.2	3.3
Primary balance [2)]	2.2	3.8	4.1	4.9	6.1	4.6
Government debt	76.1	75.2	66.8	63.1	56.1	51.8
Cyclically-adjusted balance [4)]	-2.7	-1.0	-1.3	-0.6	0.1	0.8
Cyclically-adj. primary balance [4)]	3.1	4.6	3.5	3.9	4.0	4.2

Note: For footnotes and sources see Table 1.2 for Belgium.

10.4 Economic reforms

10.4.1 Labour markets

- **Overall assessment**

11. The Dutch labour market continues to perform very well, with the lowest unemployment rate in the European Union and employment rates already above the Lisbon targets for the EU as a whole. However, the number of benefit recipients remains very high (11% of the labour force draw disability benefits and recipients of unemployment benefits and social assistance represent 7% of the labour force) and is likely to contain significant hidden unemployment.

12. Some progress was made in implementing the 2001 labour market recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendation in the 2001 BEPGs	*Degree of implementation*
➢ Continue reforms of the tax and benefit system to make work pay. Reforms should focus on the still high marginal effective tax rates, especially at the lower end, and relatively lax eligibility rules, in particular to foster labour force participation among older workers and to facilitate the labour market re-integration of people receiving passive benefits, including those receiving disability benefits.	Partial

Table 10.3: **Labour market indicators for Netherlands**

	Netherlands					EU			USA		
	1990	**1994**	**1999**	**2000**	**2001**	**1994**	**2000**	**2001**	**1994**	**2000**	**2001**
Employment rate (ER) [1)]	61.3	63.9	71.3	73.0	:	59.6	63.2	:	72.0	74.1	:
Female ER [1)]	47.1	52.9	61.7	63.6	:	49.3	54.0	:	65.2	67.9	:
Older workers ER [1)]	29.4	29.1	35.8	38.1	:	35.7	37.7	:	54.4	57.7	:
Employment growth [2)]	2.9	0.7	2.5	2.4	2.0	-0.1	1.7	1.1	2.3	1.9	-0.1
ER full time equivalent	:	51.3	56.8	57.5	:	54.9	57.9	:	:	:	:
Unemployment rate (UR)	6.2	7.1	3.4	2.8	2.3	11.1	8.2	7.8	6.1	4.0	4.8
Long-term UR [1)]	3.3	3.1	1.2	0.8	:	5.2	3.6	:	:	:	:
Youth UR (<25)*	8.6	11.4	7.1	5.6	4.7	22.1	16.2	15.5	12.4	9.3	10.6
Nominal wage growth [2)]	3.2	2.8	3.3	4.6	5.0	3.1	3.0	3.3	2.4	5.1	5.3
Real Unit Labour Cost growth [2)]	-0.4	-2.1	0.4	-0.3	-0.3	-2.4	-0.1	0.3	-1.1	0.7	1.8
Labour Productivity growth [2)]	1.4	2.6	1.2	1.1	-0.4	2.9	1.6	0.5	1.5	2.1	1.0
Tax rate on average wage earners [3)]	:	45.6	44.3	45.1	42.3	44.6	43.6	43.0	31.2	30.8	30.0
Tax rate on low wage earners[3)]	:	:	40.2	40.6	36.8	:	38.6	37.8	:	29.0	27.7
NRR on low income families (married) [4)]	:	82.0	89.0	:	:	72.0	67.0	:	59.0	59.0	:
NRR on low wage earners (single) [4)]	:	86.0	88.0	:	:	71.0	68.0	:	59.0	59.0	:

*The youth UR figure shown for 2001 for the Netherlands is the average of the seasonally adjusted monthly rates for Jan-Nov 2001.

Note: For other footnotes and sources see Table 1.3 for Belgium.

13. Addressing work incentives, the income tax credit, first introduced by the 2001 tax reform was increased and a bonus introduced for recipients of passive benefits who take up a job. The reorganisation of benefit administration and placement came into force at the start of 2002. Central and local authorities have reached an agreement on efforts to increase the coherence of benefit administration. In contrast, following the report of the Donner Commission, a reform of the disability scheme is still under discussion. Participation of older workers is addressed through the phasing out of public support for early retirement schemes. Some financial incentives to firms for hiring older workers have been introduced or are planned for introduction in 2002.

10.4.2 Product markets and the knowledge-based economy

- **Overall assessment**

14. The Dutch economy is very open (as measured by the trade-to-GDP ratio). This assures a high level of competition and relatively low price levels in sectors producing tradable goods and services. The lower level of competition in some more sheltered services sectors contributes to the relatively slow growth of labour productivity in services overall. Market liberalisation has contributed to relatively low prices for telephone calls and electricity use. The non-transposition rate of Single Market Directives has been brought down to below the Lisbon target of 1.5%. The typical costs for setting up a Private Limited Company in the Netherlands are € 585, which is around average for EU Member States. However, the time required to do so (30 business days) is above average.

15. While public expenditures on R&D as a share of GDP in 1998 were above the EU average, business expenditures were below average and less than the year before. This relatively poor performance may be associated with the lack of a science- and technology-oriented labour force. In 1999, the number of new science and technology graduates per thousand in the 20-29 years age class was 5.8, as opposed to 10.4 for the EU as a whole. In June 2001, the percentage of households with internet access at home (58.5%) was third from the top amongst EU Member States. However, the Netherlands had been in first position (in October 2000). This relative setback may be associated with the comparatively high internet access charges.

16. Good progress was made in implementing the 2001 product market recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendations in the 2001 BEPGs	*Degree of implementation*
➢ Take measures to improve the climate for innovation and to stimulate further ICT penetration, and, in particular, increase the supply of qualified ICT personnel and trained researchers.	In progress
➢ Reinforce the level of competition by further opening up public procurement and by facilitating market entry in electricity, gas, cable networks and public transport.	In progress

17. The Dutch government has taken a number of measures to stimulate research and innovation (increased budget for innovation-orientated research programmes, better conditions for techno start-ups, improved tax incentives to promote a competitive knowledge climate). In spite of this, business expenditures on R&D as a percentage of GDP have fallen further behind the EU average. Various measures have also been taken to encourage access to, and the use of, ICT. This has contributed to improved internet access in schools, better access to government services and an expansion of e-commerce. Budgetary resources for ICT training were increased and an ICT task force launched new projects aimed at reducing the shortage of ICT experts.

18. In 2000, an interdepartmental project directorate called Professional Purchasing and Procurement was created, which will further the use of electronic tendering procedures. The GDP share of public procurement tenders published in the Official Journal rose substantially, but remained below the EU average. Energy markets for wholesalers and for large and intermediate users have been liberalised. The aim is to liberalise the entire energy market on 1 January 2004. In gas, however, new players argue that third-party network access prices are higher than the implicit transport charges for customers supplied by the incumbent. In order to prevent such conflicts of interest, a bill governing the privatisation of energy companies is under discussion. The Dutch government is currently preparing legislation to guarantee open access for broadcast and Internet companies to the cable companies, which enjoy a position of economic dominance. A system of public transport concessions is gradually being implemented. With a provisional exemption for rail transport over the main line network, transport concessions are periodically awarded via a public tender.

Table 10.4: **Product market indicators for the Netherlands**

	THE NETHERLANDS				EU 15			
	1998	1999	2000	2001	1998	1999	2000	2001
Labour productivity[1]	99.2	98.2	98.7	98.4	100	100	100	100
Relative price levels[2]	95.0	97.0	97.0		100	100	100	
Total trade to GDP ratio (%)[3]	52.0	53.3	60.4	58.2	41.2	41.9	46.7	45.8
FDI share[4]	8.3	9.6	13.9		2.7	5.0	8.9	
Cross-border M&A share[5]	9.1(4.7)	8.6(4.6)	8.2(4.7)		100	100	100	
Single Market Directives[6]	3.8	2.8	2.5	1.3	3.9	3.6	3.0	2.0
Value of tenders in the O.J.[7]	1.1	1.2	2.2		1.8	1.8	2.4	
Sectoral and ad hoc State aids[8]	0.7	0.8			1.0	0.9		
Prices in telecommunications[9]								
- Local	0.32	0.32	0.30	0.31	0.41	0.41	0.41	0.41
- National	0.70	0.64	0.42	0.47	2.16	1.69	1.34	1.15
- Call to USA	2.77	0.90	0.78	0.78	5.07	4.09	3.39	2.65
Market share fixed telecom (%)[10]								
- Local		99.0	99.0					
- Long Distance		95.0	79.0					
- International		80.0	69.0					
Electricity prices[11]								
- Households	8.70	8.17	10.75	8.87	10.57	10.48	10.40	10.33
- Industry users	5.67	5.78	7.53	6.22	6.44	6.32	6.44	6.33
Market share electricity (%)[12]		32.6						
Education expenditure[7]	4.9	4.8	4.9	4.9	5.0	5.0	5.1	
New S&T graduates[13]	6.0	5.8						
R&D expenditure[7]	1.94				1.87	1.92	1.90	
Internet access at home[14]		21.0	54.8	58.5		12.0	28.4	36.1
Patent applications[15]	178.3	197.3	217.6		129.9	140.9	152.7	

Note: For footnotes and source see Table 1.4 for Belgium.

10.4.3 Capital markets

- **Overall assessment**

19. The integration of capital markets continued in 2001 with the conversion by the three Euronext exchanges of Paris, Brussels and Amsterdam to the same trading platform and the use of a single central clearing house. Overall activity in the well-developed venture capital market fared better than elsewhere in the EU, but there was a steep decline in early-stage investment, where the availability of capital is already relatively low in the Netherlands. In the banking and insurance sectors, cross-border and cross-sector mergers and acquisitions continued in 2001.

20. In response to the increasing role of financial conglomerates, the Board of Financial Supervisors was set up in July 1999 as a forum in which the various financial supervisors (banks, insurers, securities) discuss cross-sectoral issues. End 2001, the government submitted plans to Parliament, proposing a new cross-sector model for financial supervision based on a two pillar system (i) prudential supervision combined with systemic stability and (ii) conduct of business supervision under a separate supervisor. The central bank (DNB) will remain responsible for systemic stability and payment systems and will be responsible for prudential supervision of banks,

investment funds and securities firms. The insurance supervisor (PVK) will be responsible for prudential supervision of insurance companies. DNB and PVK will integrate their cross-sector activities. The securities supervisor (STE) will evolve into a new Authority for Financial Markets (AFM), responsible for securities markets as well as the conduct of business. Further to the Euronext merger, the French, Dutch and Belgian relevant financial supervisory authorities have agreed to co-ordinate their respective competencies (regarding regulation and supervision of Euronext managed markets as well as supervision of clearing activities).

21. In terms of consumer and investor protection, legislative procedures have been launched to strengthen shareholders' rights. Various policy initiatives were also taken to improve financial services' transparency vis-à-vis the consumer.

22. To facilitate start-up financing, some financial schemes were introduced (e.g. the techno starter scheme) or widened (e.g. extension of the period during which an entrepreneur is regarded as a starter for state-guaranteed loans).

23. Some progress was made in implementing the 2001 capital market recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendation in the 2001 BEPGs	*Degree of implementation*
➢ Develop the risk capital market by further adapting the fiscal framework so as to facilitate investment and entrepreneurship, the latter to be also encouraged by adjusting bankruptcy laws.	In progress

24. The possibility to grant stock options to their employees is particularly useful for young high-growth companies. The taxation of stock option has been reformed to make it possible to defer part of the taxation until the option is exercised, which will help alleviate the negative effects of their taxation at grant. As already mentioned in the Implementation Report for 2000, the Netherlands is considering a Bill to modernise the Bankruptcy Act. A follow-on process could also be launched to introduce further adjustments by which bankruptcy should become less of a stigma.

11. AUSTRIA

11.1 Macroeconomic context

1. Output growth decelerated in 2001 to about 1%, following rather buoyant economic activity during the period 1998-2000. The slowdown was caused by both domestic and external factors. Budgetary consolidation curbed both private and public consumption. Worsening business confidence and excess capacities reined in equipment investment, while construction investment plunged due to market saturation and budgetary restraint. Exports fell in step with the deterioration of the external environment, but due to a strong deceleration in import growth the contribution of net exports to output growth remained clearly positive. The slowdown started to affect the labour market, with employment growth slowing and unemployment rising from the beginning of the year onwards. Oil price developments and an increase in excise duties and charges dominated price developments. Inflation peaked in summer but has shown signs of easing since, with HICP inflation estimated to average 2.3% in 2001.

Table 11.1: **Economic developments in Austria**[1)]

	1992-97	1998	1999	2000	2001
Real GDP	1.8	3.5	2.8	3.0	1.1
Domestic demand	2.1	2.7	2.8	2.5	0.6
Private consumption	2.3	2.8	2.7	2.5	1.4
GFCF (Investment)	1.6	3.4	1.5	5.1	-0.2
Exports (G&S)	4.3	7.9	8.7	12.2	5.3
Imports (G&S)	5.1	5.9	8.8	11.1	4.4
Inflation [2)]	2.3	0.8	0.5	2.0	2.3*
Compensation/employee	3.6	2.8	2.4	2.1	2.4

Note: For footnotes and sources see Table 1.1 for Belgium.

11.2 Key challenges

2. Whereas Austria made progress in implementing the recommendations of the 2001 BEPGs, a number of key policy issues require continued attention, in particular the sustainability of public finances, the competition framework in several sectors and the technology base.

Key economic policy challenges for Austria

- Ensuring the sustainability of public finances in view of high and rising outlays for pension benefits and continued very low employment rates in higher age brackets.
- Strengthening the framework for effective competition in several sectors.
- Improving the weak technology base, which risks endangering the transition to a knowledge-based economy.

3. In the absence of policy reform significant budgetary imbalances are to be expected in the long term due to the expenditure pressure caused by an ageing population. Ageing-related public spending has been estimated to increase by 6% of GDP between 2005 and 2040. The improved budget balance in recent years is a necessary step to meet the costs of ageing populations. The budgetary challenge stems not only from increased spending on pension and health care but also from its level, which as a share of GDP is one of the highest in the EU. As a consequence, in order to avoid substantial increases in an already high tax burden, employment rates, especially among women and older workers, will have to be raised. This requires, *inter alia*, that tax and pension schemes provide appropriate incentives for older workers to remain longer in the labour market. Recent pension scheme reforms have indeed addressed this issue. However, much remains to be done to achieve the very large increase in the effective retirement age or the substantial rise in older-worker participation rates necessary to put the pension system on a sustainable footing. In addition, the newly introduced child-care allowances may have an ambiguous effect on the female participation rate. Recent measures regarding health care go in the right direction, but additional efforts are needed to contain the strong expenditure pressures that will be triggered by an ageing population. Even after the pension reform of 2000, Austria will continue to spend more in terms of GDP on public pensions than any of the other EU countries. At the same time, the employment rate of older workers is, at 35%, relatively low and seems to be stagnating.

4. The slow development in the application of some Single Market rules has the potential to adversely affect competition and the smooth functioning of the Single Market. Firstly, following a period of sizeable efforts to cut the non-transposition rate of directives, latest figures show that this has stagnated at 2.9%, well above the 1.5% target. Secondly, plans to harmonise federal and regional procurement legislation date from 1999, but no legislative steps have been taken so far. Thirdly, Austria is one of the few countries that have not yet explicitly empowered its competition authority to apply EC law. These shortcomings within the framework of competition may result in a lack of competition on product markets.

5. The conditions for a rapid transition to the knowledge-based economy are not yet fully in place. Business spending on R&D is below the EU average and the same diagnosis applies to ICT expenditures. These weaknesses are translated into a narrow technology base, which results in a structural current account deficit. Different initiatives have been taken to encourage links between universities and industries, to develop innovation at regional level, to promote IT initiatives, and to increase the supply of ICT personal. These measures are structural and of a long-term nature, so that it is too early to see their effects.

11.3 Public finances

- **Overall assessment**

6. Budgetary consolidation in 2001 was impressive. General government finances improved from a deficit of 1.5% of GDP (excluding UMTS proceeds) to a balanced position. As this was achieved against output growth of slightly above 1% of GDP the improvement in the cyclically-adjusted position was even stronger. Expenditure growth was kept at bay thanks to the ongoing effect of the reform of the pension system and public administration. Due, however, to exceptional one-off expenditure, the ratio of expenditure-to-GDP (excluding UMTS proceeds) rose slightly compared to the previous year; it is, however, projected to fall visibly in 2002. The favourable outcome in 2001 is

mainly due, therefore, to better than expected tax income. The stability programme update projects a balanced budget also for the year 2002. To attain the medium term targets of the programme, structural savings measures will be needed also at the level of the Länder which committed themselves to considerable surpluses in the framework of a national stability pact. Despite recent structural reforms, the sustainability of the pension system is not secured in view of the sharp rise in the age-dependency ratio in coming decades.

7. Good progress was made in implementing the 2001 public finance recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendations in the 2001 BEPGs	*Degree of implementation*
➢ Ensure tight budgetary execution at all levels of government in both 2001 and 2002 in order to meet the targets of the December 2000 update of the stability programme of respectively, 0.75 and 0 per cent of GDP; realise expenditure savings as planned in the stability programme, in particular in the area of administrative reform and the social security sector.	2
➢ In the following years reduce the high tax burden, in particular on labour, without however jeopardising the budgetary consolidation objectives; this will call for additional and permanent expenditure savings.	No new measures
➢ In view of long term challenges - notably resulting from population ageing – continue reforms in the pension system: in particular review already in 2001 benefit levels and reconsider access to invalidity pensions in order to increase the average retirement age; in the health care sector: take measures to counter the rising spending pressures.	Partial

8. The updated stability programme of November 2001 estimates general government finances in 2001 to be in balance. This means that the objective of a balanced budget was achieved one year ahead of schedule despite much lower output growth than projected. Expenditure savings were realised owing to the effects of the ongoing reforms of the pension system and public administration. The better than expected outcome was due, however, to tax revenue which was significantly above expectations. The introduction of interest charges on tax arrears led to exceptionally strong advance payments in 2001. Assuming that, in the absence of this measure, part of these payments would have occurred in the following year, tax income in 2002, which will be also dampened by sluggish growth, might be susceptible to shortfalls in comparison with the budget plan.

9. Tax income in 2001 grew much above estimated nominal GDP (9% versus 2¾%) thanks mainly to measures broadening the tax base and the above-mentioned introduction of interest charges on tax arrears. As a consequence, the tax burden rose by 1¾ percentage points to close to 48% of GDP, thereby further increasing the difference with the EU average. Reducing the tax burden will thus be of primary importance in the years to come. The announced reduction in non-wage labour cost amounting to 0.3% of GDP, which was originally planned for 2002, has been postponed by one year. The

government plans to reduce the tax burden to 40% of GDP by the end of this decade but this announcement needs yet to be complemented by concrete measures.

10. The recent pension reform increased the retirement age for early retirement. This is an important step in the right direction because the current system encourages early retirement at the earliest possible moment. However, significant further structural reforms are needed to secure the sustainability of public finances, with the old-age dependency ratio increasing sharply over the next few decades. This should be seen against the background of pension expenditure as a share of GDP in Austria being the highest in the EU. Benefit levels are high due, *inter alia*, to the weak link to actual pension contributions. Nevertheless, the rise in pension benefits has been moderate in recent years due to annual adjustments, on average, below nominal GDP growth.

Table 11.2: **Trends in public finances in Austria** [1)]

	1994	**1996**	**1998**	**1999**	**2000**	**2001**
Government balance [2)]	-5.0	-3.8	-2.4	-2.2	-1.1	-0.2
- Total revenue	52.4	52.8	51.9	51.6	51.1	52.7
Tax burden [3)]	41.9	43.7	44.6	44.5	43.9	45.6
- Total expenditure	57.4	56.6	54.3	53.8	52.2	52.9
Primary current expenditure	45.7	45.0	43.7	43.6	43.0	43.2
Interest payments	4.1	4.2	3.8	3.5	3.5	3.4
Investment	3.3	2.8	1.9	1.8	1.7	1.6
Primary balance [2)]	-0.9	0.4	1.4	1.3	2.4	3.2
Government debt	64.7	69.2	63.9	64.9	63.5	62.3
Cyclically-adjusted balance [4)]	-5.1	-3.6	-2.4	-2.4	-1.9	-0.3
Cyclically-adj. primary balance [4)]	-1.0	0.6	1.4	1.2	1.6	3.1

Note: For footnotes and sources see Table 1.2 for Belgium.

11.4 Economic reforms

11.4.1 Labour markets

- **Overall assessment**

11. The overall performance of the Austrian labour market remained very satisfactory in 2001, and the unemployment rate, although it has started to increase, is still among the lowest in the EU. However, while the total employment rate is above the EU average, the employment rate of older workers appears to be stagnating at a relatively low level (34.6%).

12. Some progress was made in implementing the 2001 labour market recommendation.

- **Implementation of the 2001 BEPGs**

Country-specific recommendation in the 2001 BEPGs	*Degree of implementation*
➢ Further reform tax and benefit systems to increase incentives for older workers to remain active in the labour market.	Partial

13. The full effect of the reforms introduced in late 2000 (i.e. an increase of the early retirement age by 18 months to 56½ and 61 years, and an increase in bonuses and deductions) on the average retirement age is not yet clearly visible, but the inflow into early retirement has started to decline. Since then, measures have been taken to strengthen (pre-emptive) training for older workers. However, research by the IHS suggests that disincentives to working after the minimum age for early retirement remain strong, in particular for low wage earners, and that invalidity pensions could be used to side-track the restricted early retirement scheme.

Table 11.3: **Labour market indicators for Austria**

	Austria					**EU**			**USA**		
	1990	**1994**	**1999**	**2000**	**2001**	**1994**	**2000**	**2001**	**1994**	**2000**	**2001**
Employment rate (ER) [1)]	:	68.3	68.5	68.4	:	59.6	63.2	:	72.0	74.1	:
Female ER [1)]	:	58.9	59.6	59.6	:	49.3	54.0	:	65.2	67.9	:
Older workers ER [1)] *	:	28.0	30.1	28.8	:	35.7	37.7	:	54.4	57.7	:
Employment growth [2)]	1.6	-0.1	1.2	0.5	0.0	-0.1	1.7	1.1	2.3	1.9	-0.1
ER full time equivalent	:	:	63.9	63.5	:	54.9	57.9	:	:	:	:
Unemployment rate (UR)	:	3.8	3.9	3.7	3.8	11.1	8.2	7.8	6.1	4.0	4.8
Long-term UR [1)]	:	1.0	1.1	1.0	:	5.2	3.6	:	:	:	:
Youth UR (<25)	:	5.7	5.4	5.3	5.7	22.1	16.2	15.5	12.4	9.3	10.6
Nominal wage growth [2)]	5.4	4.0	2.4	2.1	2.4	3.1	3.0	3.3	2.4	5.1	5.3
Real Unit Labour Cost growth [2)]	-1.1	-1.5	-0.2	-0.7	-0.1	-2.4	-0.1	0.3	-1.1	0.7	1.8
Labour Productivity growth [2)]	3.1	2.8	1.8	1.6	1.1	2.9	1.6	0.5	1.5	2.1	1.0
Tax rate on average wage earners [3)]	:	39.7	45.9	44.9	44.7	44.6	43.6	43.0	31.2	30.8	30.0
Tax rate on low wage earners[3)]	:	:	41.6	40.1	39.9	:	38.6	37.8	:	29.0	27.7
NRR on low income families (married) [4)]	:	71.0	76.0	:	:	72.0	67.0	:	59.0	59.0	:
NRR on low wage earners (single) [4)]	:	57.0	61.0	:	:	71.0	68.0	:	59.0	59.0	:

Note: For footnotes and sources see Table 1.3 for Belgium.

11.4.2 Product markets and the knowledge-based economy

- **Overall assessment**

14. The Austrian economy is relatively less open (as measured by the total trade-to-GDP ratio) than other smaller Member States. The functioning of product market is improving with a decrease in price levels and an increased labour productivity. Network industries are being liberalised rapidly and a new electricity regulator has been appointed. The share of public procurement advertised has significantly increased from 1.3% to 2.3% of GDP between 1999 and 2000. The time and costs requirements to register a company are minimal for sole traders but still high for private limited companies. However, important shortcomings subsist in the competition framework and the Single Market transposition deficit remains significantly high at 2.9%.

15. Weak competition in some sectors of the economy results in too little pressure on companies to innovate, as suggested by the low share of business R&D expenditure. Sizeable efforts have been made to strengthen R&D expenditure and develop ICT. The use of the internet has started to boom and e-government initiatives are developing. ICT-skilled shortages, Austria's lag in e-learning, and the low level of start-ups may indicate problems in setting up a strong technology base.

16. Some progress was made in implementing the 2001 product market recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendations in the 2001 BEPGs	*Degree of implementation*
➢ Transpose the Community's public procurement directives and further open up public procurement to competition, in particular at the provincial and local level	Partial
➢ Implement fully the announced reforms to promote the development of the knowledge economy and take measures to increase the supply of ICT-skilled personnel.	In progress

17. The EU directive on public procurement has been transposed but the 1999 recommendation to harmonise Federal and Regional procurement legislation is still being discussed in the Parliament. The aim is to set up a single law compared with 10 existing regional laws today. A step has been made with the establishment of a Federal Procurement Company (*Bundesbeschaffung GMbH*), which is taking over the duties of the entire federal administration in terms of public procurement, but its powers are limited to an advisory role. However, there are indications that public procurement is being more openly advertised as Austria is closing the gap with the EU average both in terms of its value in percentage of GDP and as a proportion of total public procurement.

Table 11.4: **Product market indicators for Austria**

	AUSTRIA				EU 15			
	1998	1999	2000	2001	1998	1999	2000	2001
Labour productivity[1]	95.0	96.5	97.6	97.6	100	100	100	100
Relative price levels[2]	106.0	101.0	100.0		100	100	100	
Total trade to GDP ratio (%)[3]	31.6	32.7	36.8	37.5	41.2	41.9	46.7	45.8
FDI share[4]	1.7	0.7	4.6		2.7	5.0	8.9	
Cross-border M&A share[5]	1.8(2.6)	3.1(2.5)	3.0(2.4)		100	100	100	
Single Market Directives[6]	4.2	3.7	2.9	2.9	3.9	3.6	3.0	2.0
Value of tenders in the O.J.[7]	1.47	1.25	2.31		1.8	1.8	2.4	
Sectoral and ad hoc State aids[8]	1.0	0.9			1.0	0.9		
Prices in telecommunications[9]								
- Local	0.80	0.80	0.64	0.64	0.41	0.41	0.41	0.41
- National	2.30	2.30	1.84	0.77	2.16	1.69	1.34	1.15
- Call to USA	5.76	6.08	4.32	4.32	5.07	4.09	3.39	2.65
Market share fixed telecom (%)[10]								
- Local		85.0						
- Long Distance		85.0						
- International		85.0						
Electricity prices[11]								
- Households	9.70	9.79	9.52	9.47	10.57	10.48	10.40	10.33
- Industry users	7.56	7.49			6.44	6.32	6.44	6.33
Market share electricity (%)[12]		51.7						
Education expenditure[7]	6.3	6.3			5.0	5.0	5.1	
New S&T graduates[13]	4.2	4.0						
R&D expenditure[7]	1.81	1.83	1.79		1.87	1.92	1.90	
Internet access at home[14]		12.0	38.0	46.2		12.0	28.4	36.1
Patent applications[15]	142.3	140.3	154.1		129.9	140.9	152.7	

Note: For footnotes and source see Table 1.4 for Belgium.

18. The government has set up the *Technologie Impulse Gesellschaft* (TIG), which is responsible for implementing technology- and regional policy projects and aims at fostering collaborations between science and industry. Several R&D funding programmes encourage links between universities and industry as well as innovation at the regional level. Other projects include risk capital, marketing of R&D and information dissemination. The "e-Austria in e-Europe" initiative is going to develop IT initiatives. Finally, the EU directive on e-commerce has been implemented and will be effective from 2002 onwards. To increase the supply of ICT-skilled personnel, the Foreigners Employment Act (*Ausländerbeschäftigungsgesetz*) has been modified in order to facilitate the recruitment of foreign ICT experts. The one-stop shop principle will be applied for the recruitment of key personnel to meet labour markets needs.

11.4.3 Capital markets

- **Overall assessment**

19. Vienna's ATX index was the only main EU stock market index to end higher over the full year 2001, but the attractiveness of Austria's equity market continued to suffer from low rates of widely distributed equity ownership and - though decreasing - a high level of preference shares. As mergers and acquisitions have reduced the number of

companies listed in the ATX segment, the Wiener stock exchange created a new Prime Market segment (ATX-P) at the beginning of 2002, which will include 30 to 40 enterprises with a comparably high and widely distributed share of equity ownership (and excluding preference shares), applying international accounting standards (IAS or US-Gaap). The creation of a new "Third Market" segment for Austrian equities by an amendment to the Stock Exchange Act passed in January 2001, but the admission of the Third Market onto the European List of regulated markets has not yet been affirmed.

20. The process of consolidation in the Austrian banking sector continued in 2000 and 2001, with the focus increasingly on internal consolidation. The number of bank branches diminished slightly together with the number of employees. Austrian banks are still very active in central and eastern European countries with a special focus on the Slovak Republic, followed by the Czech Republic, Hungary, Croatia and Poland.

21. In the field of capital market reforms, several legal modifications (doubled allowances for the financial participation of employees, a tax relief for stock options and an abolition of inheritance tax on corporate shares by succession upon death) came into effect in January 2001. The Share-Option Act of April 2001 regulates the conditions for granting share options to executives and staff members of the corporations concerned.

22. The responsibility for the supervision of banking, insurance and pension funds will be outsourced from the Ministry of Finance to a new "all-finance supervisory authority", which will also take over the supervision of securities from the Securities Supervisory Board. The Financial Market Supervisory Authority (FMA) will become operative on 1 April 2002. It will have the mandate to co-operate with supervisory authorities from other countries and the power to impose administrative fines.

23. Good progress was made in implementing the 2001 capital market recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendations in the 2001 BEPGs	*Degree of implementation*
➢ Develop further the risk capital market by easing constraints on institutional investment in equity capital, by establishing a fiscal framework more conductive to investment and entrepreneurship.	In progress

24. Investment conditions for pension funds were improved by allowing investments of up to 5% in assets not previously listed in the catalogue of permissible investments. Regarding the creation of a fiscal framework more conductive to investment, the above-mentioned legal modifications came into effect at the beginning of 2001. In addition, Austria has abolished the registration fee for start-ups. A "stimulation program" adopted in December 2001 foresees an extension of tax incentives for "new" start-ups to acquisitions of existing "start-up" companies.

12. PORTUGAL

12.1 Macroeconomic context

1. Economic activity decelerated from 3.4% during 1999-2000 to 1.7% in 2001, as the slowdown in the growth contribution of domestic demand was only partly offset by the improvement of exports. The slowdown in domestic demand reflects the efforts of private sector agents to redress their balance sheets, following the sharp rise in their indebtedness in recent years. The rapid rise in private sector agents' indebtedness since the mid-1990s is mirrored in the high external deficit, which recorded an estimated 7% of GDP in 2001. Labour market developments remained positive in 2001. The standardised unemployment rate remained below 4½%, and total employment rose by about 1½%. Wages per head have accelerated to over 6%, reflecting the tightness in the labour market, combined with strong wage increases in the public sector. Inflation measured by the HICP peaked at 4.4% in 2001 on the back of some temporary factors such as the oil price hike, bad weather conditions and the BSE scare, although demand pressures also played a role. Since the second quarter of 2001, the inflation rate started to decline (year-on-year).

Table 12.1: **Economic developments in Portugal**[1)]

	1992-97	1998	1999	2000	2001
Real GDP	2.0	4.5	3.4	3.4	1.7
Domestic demand	2.5	6.7	5.5	3.0	0.7
Private consumption	2.3	5.1	4.8	2.6	1.1
GFCF (Investment)	4.6	11.2	7.1	5.3	-1.0
Exports (G&S)	5.2	9.2	3.2	8.1	6.2
Imports (G&S)	6.3	14.2	8.7	6.0	2.7
Inflation [2)]	4.7	2.2	2.2	2.8	4.4*
Compensation/employee	7.8	3.7	4.2	6.3	6.4

Note: For footnotes and sources see Table 1.1 for Belgium.

12.2 Key challenges

2. Whereas Portugal made progress in implementing the 2001 BEPGs recommendations, a number of key policy issues require continued attention, in particular the consolidation of public finances, overall competitiveness and the longer-term sustainability of public finances.

Key economic policy challenges for Portugal

- Consolidating public finances to reverse the effects of a rapid growth in the public sector in recent years, as evidenced by an increased tax burden and public sector employment, which puts upward pressure on nominal wage growth.
- Increasing the overall competitiveness, which is currently at risk from the extension of public sector employment and increases in taxation, with knock-on effects on wage formation; low efficiency of education and low R&D spending; as well as a lack of competition in several areas of product markets.
- Ensuring the longer-term sustainability of public finances, in particular the need to adapt the pension reform.

3. The consolidation of public finances remains a major economic policy challenge in the coming years. Fiscal consolidation faltered in 2001 due to a significant shortfall in revenue. The main reasons for this shortfall are the economic slowdown and an underestimation of the impact of the reform of direct taxes implemented in 2001, as well as less favourable developments in current primary expenditure, which were only partly compensated by lower than projected capital expenditure. The risk of a slippage was identified already in the first half of 2001, compelling the government to adopt a corrective budget in June, which involved savings in current primary expenditure amounting to an estimated €750 million (about 0.6% of GDP). However, these cuts were not sufficient to prevent a marked deterioration in the general government deficit, which rose from 1.8% of GDP in 2000 (excluding UMTS proceeds) to 2.2% in 2001. This compares with a deficit target of 1.1% of GDP set in the January 2001 update of the stability programme. Despite the significant upward revision of the government deficit in 2001, the December 2001 update of the stability programme maintains the target of balancing general government accounts in 2004, implying a considerably more demanding path of fiscal consolidation in the period 2002-04. The reversal of the rapid public sector growth in recent years must be, among other measures, a priority matter on the road to a sounder public finance position.

4. A number of factors have contributed to a low competitiveness of the Portuguese economy, as evidenced by the low level and growth of labour productivity. The low level of educational attainment of the workforce continues to be one of the most serious structural problems. The incidence of early dropouts from the education system is much higher in Portugal than in other Member States. Portugal's problem is not necessarily inadequate spending on education, but probably a relatively inefficient use of resources. R&D investments, particularly by the business sector, are among the lowest in the EU as a share of GDP. Although this may in good part be attributed to the enterprise structure and industrial specialisation of the economy, the overall weak R&D and innovation performance may deprive Portugal of an important source of productivity gains. The pursuit of higher levels of productivity is also constrained by insufficient competition in several areas of product markets, in particular in network industries, possibly also due to remaining obstacles to the full and effective application of competition policy.

5. Portugal is one of the EU countries most exposed to the budgetary consequences of population ageing. Public spending on pensions and on health care relative to GDP are estimated to increase by more than 3 percentage points between 2005 and 2050. In order to address the budgetary consequences of an ageing population, the formula used to calculate public pensions was changed. It now relies on the entire working career, instead of the best 10 years out of the last 15 years. This change was coupled with new rules for the actualisation of past wages which guarantee only a partial indexation of wages to productivity rises. The regulations regarding complementary pensions are to be approved until the end of 2002. In addition, the government has strengthened a public-owned capitalisation fund, which is to receive at least 2 out of 11 percentage points of employees' contributions. These reforms will improve the long-term sustainability of the (pay-as-you-go) pension system, but further action will be needed. Moreover, the strong dynamics of health-related expenditure suggest that the long-announced measures to improve the quality and efficiency in the health care sector need to implemented urgently.

12.3 Public finances

- **Overall assessment**

6. Fiscal consolidation halted in 2001, with the government deficit increasing to an estimated 2.2% of GDP (1.8% in 2000 excluding UMTS proceeds) compared to a target of 1.1%. Despite the significant upward revision of the government deficit in 2001 the December 2001 update of the stability programme maintains the objective of balancing general government accounts by 2004, implying a considerably more demanding path of fiscal consolidation in the period 2002-04. Achieving balance in 2004 will be important given that Portugal is one of the EU countries most exposed to the budgetary consequences of population ageing. A recent agreement between social partners on a reform of the pension system implies a significant step towards the sustainability of government finances. In addition, the government has strengthened a publicly owned capitalisation fund, which is to receive at least 2 out of 11 percentage points of employees' contributions. These reforms are considered to strengthen the long-term sustainability of the (pay-as-you-go financed) pension system but further action will be needed to that effect. Moreover, the strong dynamics of health care expenditure suggest that the long-announced measures to improve the quality and efficiency in the health care sector need to implemented urgently.

7. Some progress was made in implementing the 2001 public finance recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendations in the 2001 BEPGs	*Degree of implementation*
➢ Meet the 1.1 per cent of GDP deficit target for 2001, which calls for a strict adherence to the current primary expenditure plans; if needed, do not use the current expenditure amounts frozen in the budget for 2001 to avoid cutting back government investment plans.	Partial
➢ Prepare a budget for 2002 which aims at a faster decline in the deficit ratio than planned in the 2001 updated stability programme and meet the medium-term target of a balanced budget by 2004 at the latest; such an acceleration of budgetary consolidation should be based on expenditure restraint rather than on tax increases.	In progress
➢ Underpin the process of budgetary consolidation by introducing already in 2001 additional measures in the area of health care to improve expenditure control and efficiency and by implementing expeditiously the enabling legislation required by the recently adopted social security law to strengthen the financial position of the social security sector in the light of the budgetary challenges of an ageing population.	Partial

8. The general government deficit increased from 1.8% of GDP in 2000 (excluding UMTS proceeds) to an estimated 2.2% in 2001. The unexpected economic slowdown was an important factor behind this development. However, other factors contributed as well, in particular an underestimation of the impact of the 2001 tax reform on tax revenues, lower than planned gains in the efficiency of tax collection and administration, and less

favourable developments in current primary expenditure that were only partly compensated by lower than planned capital expenditure. The government identified the risk of the deficit exceeding the target in June 2001 and adopted a corrective budget involving savings in current primary expenditure amounting to an estimated € 750 million (about 0.6% of GDP). However, these cuts were not sufficient to prevent a marked deterioration in the general government deficit.

9. According to the December 2001 update of the stability programme, in 2002 the general government deficit is projected to decline by 0.4% of GDP to 1.8% of GDP compared to a target of 0.7% of GDP in the previous programme update. The medium-term target of a balanced budget in 2004 is maintained. The projected decline in the deficit is brought about exclusively through restraint current primary expenditure, as recommended by the BEPGs. This is based on capping the annual growth of nominal current primary expenditure for central government at 4%, substantially below the projected nominal GDP growth, combined with structural reforms in a number of areas directly impacting on government finances. In view of the deterioration in the starting position, but also because of a less favourable economic environment, the underlying consolidation requirement in 2002 and the following years has increased considerably.

10. The reform of the health care sector is still under progress. Legislation was adopted allowing for private-public partnerships in hospitals. However, important measures are yet to be implemented, *inter alia*, the widespread use of generic drugs, conventions with the medical industry, the reorganisation of hospitals' pharmacies, and the progressive adoption of market based practices in the National Health Service (NHS).

Table 12.2: **Trends in public finances in Portugal** [1)]

	1994	**1996**	**1998**	**1999**	**2000**	**2001**
Government balance [2)]	:	-3.9	-2.4	-2.1	-1.5	-2.2*
- Total revenue	:	41.6	41.3	42.8	42.8*	44.0*
Tax burden [3)]	:	34.6	34.9	36.1	37.1*	36.6*
- Total expenditure	:	45.5	43.7	44.9	44.2	46.2*
Primary current expenditure	:	34.1	34.1	35.3	36.3*	36.9*
Interest payments	:	5.3	3.4	3.2	3.1	3.1
Investment	:	4.2	3.9	4.1	3.8	4.1*
Primary balance [2)]	:	1.4	1.1	1.1	1.7	0.9*
Government debt	62.0	62.7	54.8	54.5	53.6	55.9*
Cyclically-adjusted balance [4)]	:	-3.4	-2.7	-2.6	-2.5	-2.5
Cyclically-adj. primary balance [4)]	:	2.0	0.8	0.6	0.6	0.7

Note: For footnotes and source see Table 1.2 for Belgium.

12.4 Economic reforms

12.4.1 Labour markets

- **Overall assessment**

11. The Portuguese labour market situation continued to be favourable in 2001. The unemployment rate remained one of the lowest in the EU, and the employment rate increased to 68.3%, which is well above the EU-average. On the other hand, the low level of educational attainment of the work force is a serious problem for the adaptability of the labour market and the transition to the knowledge-based society.

12. Some progress was made in implementing the 2001 labour market recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendations in the 2001 BEPGs	*Degree of implementation*
➢ Increase investments in and improve education and training systems in order to raise the employability, adaptability and productivity of the labour force.	In progress
➢ Enhance, together with Social Partners, quality of work and promote modernisation of the labour market institutions, adapting labour regulations and continuous training, in order to minimise the risk of segmentation between regular and atypical contacts.	Partial

13. Portuguese labour market policy focuses on training and retraining the active population, on integrating persons in (or at risk of) social exclusion and on the quality of employment (e.g. on working conditions). More specifically, a great number of measures were gradually introduced throughout a three-year period to improve education, vocational training and life-long learning. However, as indicated in the 2001 National Action Plan for Employment, there may be an excessive number of active policies in Portugal, and the government aimed at simplifying and systemising such measures in 2001 following an efficiency evaluation of two major programs (INTERJOVEM and REAGE) in 2000. A reform of the education system is currently being implemented, which aims at changing the curriculum system, decentralising resources and enhancing efficiency in the educational system, e.g. by grouping several schools together.

14. Employment creation has been strongly concentrated to fixed-term contracts in recent years, increasing the share of workers with temporary contracts to 20% in 2000 (compared to 11% in 1996). No major initiative has been undertaken to ease the strict employment protection legislation for workers with regular contracts in 2001, even if the 2001 National Progress Report refers to incentives given to employers to change fixed-term contracts into permanent contracts. Some progress has been made on the social dialogue, as two tripartite agreements were signed on “employment policy, labour market, and education and training” and on “working conditions, occupational health and safety, and combating occupational accidents” in February 2001, with the aim of modernising the labour market. The government and the Social Partners continue to discuss two additional agreements on “work organisation, productivity and wages” and

on "improvement of social protection by defending the sustainability of the system and the business", but with limited success so far.

Table 12.3: **Labour market indicators for Portugal**

	Portugal					**EU**			**USA**		
	1990	**1994**	**1999**	**2000**	**2001**	**1994**	**2000**	**2001**	**1994**	**2000**	**2001**
Employment rate (ER) [1)]	66.3	63.3	67.4	68.2	:	59.6	63.2	:	72.0	74.1	:
Female ER [1)]	54.3	54.4	59.4	60.3	:	49.3	54.0	:	65.2	67.9	:
Older workers ER [1)]	47.5	45.8	50.9	51.0	:	35.7	37.7	:	54.4	57.7	:
Employment growth [2)]	1.7	-1.0	1.8	1.7	1.5	-0.1	1.7	1.1	2.3	1.9	-0.1
ER full time equivalent	:	62.1	65.7	66.6	:	54.9	57.9	:	:	:	:
Unemployment rate (UR)	4.8	6.9	4.5	4.1	4.1	11.1	8.2	7.8	6.1	4.0	4.8
Long-term UR [1)]	2.1	2.7	1.7	1.7	:	5.2	3.6	:	:	:	:
Youth UR (<25)	10.8	15.0	9.0	8.9	9.2	22.1	16.2	15.5	12.4	9.3	10.6
Nominal wage growth [2)]	19.2	5.6	4.2	6.3	6.4	3.1	3.0	3.3	2.4	5.1	5.3
Real Unit Labour Cost growth [2)]	3.1	-3.5	-0.7	1.5	2.2	-2.4	-0.1	0.3	-1.1	0.7	1.8
Labour Productivity growth [2)]	2.2	2.0	1.5	1.7	0.2	2.9	1.6	0.5	1.5	2.1	1.0
Tax rate on average wage earners [3)]	:	34.1	33.4	33.5	32.5	44.6	43.6	43.0	31.2	30.8	30.0
Tax rate on low wage earners[3)]	:	:	30.2	30.4	29.6	:	38.6	37.8	:	29.0	27.7
NRR on low income families (married) [4)]	:	77.0	79.0	:	:	72.0	67.0	:	59.0	59.0	:
NRR on low wage earners (single) [4)]	:	89.0	102.0	:	:	71.0	68.0	:	59.0	59.0	:

Note: For footnotes and sources see Table 1.3 for Belgium.

12.4.2 Product markets and the knowledge-based economy

- **Overall assessment**

15. Partly because of its geographical position, the Portuguese economy is relatively less open (as measured by the total trade-to-GDP ratio) than other Member States of comparable size. Price levels are the lowest in the EU, as is labour productivity, which is growing only slowly. Progress was made in completing the Internal Market, although at 2.5% the transposition deficit is still relatively high. Sector-specific aids remain the highest in the EU and decrease at a slow pace, and little progress was made in reinforcing the institutional capacity for the enforcement of competition policy. The simplification of the administrative procedures for businesses continued during 2001, but the delays to set up a new company remain high. Liberalisation has progressed in fixed telecommunications and electricity, which should contribute to reducing the relatively high prices.

16. The levels of educational attainment of the population remain weak, despite above-EU average spending on education. Portugal's innovation performance, as evidenced by indicators on R&D investments (particularly low in the business sector) and patents is also relatively low. ICT diffusion continued during 2001 also thanks to the numerous initiatives sponsored by the government. However, overall internet penetration in

households is below the EU average, as is the number of pupils connected to the internet.

17. Good progress was made in implementing the 2001 product markets recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendations in the 2001 BEPGs	*Degree of implementation*
➢ Enhance efforts to raise the level of R&D investments, particularly by the business sector.	In progress
➢ Further promote the diffusion of ICT, in particular by taking measures to increase the supply of skilled ICT personnel.	In progress
➢ Sustain the progress made in containing State aids (particularly sector-specific ones).	Partial
➢ Step up efforts to liberalise energy sectors, particularly for the benefit of small business users and households.	Partial
➢ Continue progress made in transposing internal market directives.	2

18. Several measures were enacted to increase businesses' involvement in R&D and innovation in the framework of the "Integrated Programme for the Support of Innovation". During 2001, the system of tax incentives for business R&D was expanded and government resources for the promotion of R&D further increased. Emphasis is also placed on developing firms' capacity to absorb knowledge generated elsewhere. The development of skills is considered crucial, as is the object of a variety of initiatives, in particular those aimed at increasing the number and qualifications of science students and researchers and encouraging their mobility to the private sector. Another key component of the R&D and innovation policy is the reinforcement of the links between the business sector, universities and public research centres.

19. Diffusion of ICT continued to be sustained during 2001. Under the supervision of the Inter-ministerial Commission for Information Society, a whole range of initiatives (partly supported by the EU Structural Funds) were taken to promote ICT take up by companies, families, students and the public sector. Special attention is given to the participation of SMEs in the digital economy. Emphasis is put on both the setting up of the physical and legal infrastructure for the development of ICT, and the building of relevant skills. With specific reference to the latter, recent initiatives include the creation of a "basic ICT skills diploma" accessible to all citizens, the strengthening of ICT training in basic education, and steps for the progressive insertion of ICT training in at least 50% of training programmes.

20. Portugal is still among the Member States with the highest levels of ad hoc and sector-specific aid, which decrease only at a slow pace. The current level of aid mainly reflects the large aids to financial service companies and international centres established in the Free Zone of the outermost region of Madeira. The aid scheme for the years 2001-06 is currently being reviewed by the European Commission and is expected to decrease also in the light of the results of a study evaluating its cost effectiveness.

21. The Energy regulator has taken measures to guarantee third parties' non-discriminatory access to the infrastructure for electricity transmission and distribution, and has imposed

price-caps to promote efficiency gains. This has led to a further reduction of the costs for transmission and distribution. However, possibly due to the strong position of the incumbent EDP, electricity prices for households remain above the EU average and have not decreased substantially in recent years. While 30% of the market is theoretically open to competition, only 2.5% of eligible clients have actually exercised their freedom to choose. Competition on the market should be boosted once the 2001 agreement on creating an integrated Iberian market for electricity becomes a reality. The gas market still benefits from a derogation until 2007 due to its emerging nature. In anticipation of liberalisation, some elements of the EU gas directive were transposed in 2000.

22. Progress continued on completing the Internal Market, as indicated by the decreasing deficit in transposing EU directives, which passed from 4.4% in 2000 to 2.5% in 2001. However, the transposition deficit still remains above the 1.5% target.

Table 12.4: **Product market indicators for Portugal**

	PORTUGAL				**EU 15**			
	1998	1999	2000	2001	1998	1999	2000	2001
Labour productivity[1]	65.7	65.6	65.3	64.9	100	100	100	100
Relative price levels[2]	72.0	73.0	74.0		100	100	100	
Total trade to GDP ratio (%)[3]	28.3	28.3	29.2	28.2	41.2	41.9	46.7	45.8
FDI share[4]	2.1	0	3.5		2.7	5.0	8.9	
Cross-border M&A share[5]	1.3(1.3)	1.3(1.3)	1.4(1.4)		100	100	100	
Single Market Directives[6]	5.6	4.9	4.4	2.5	3.9	3.6	3.0	2.0
Value of tenders in the O.J.[7]	2.2	2.1	2.1		1.8	1.8	2.4	
Sectoral and ad hoc State aids[8]	1.4	1.3			1.0	0.9		
Prices in telecommunications[9]								
- Local	0.25	0.27	0.23	0.30	0.41	0.41	0.41	0.41
- National	2.53	2.15	1.28	1.13	2.16	1.69	1.34	1.15
- Call to USA	6.13	4.23	3.68	2.89	5.07	4.09	3.39	2.65
Market share fixed telecom (%)[10]								
- Local		100						
- Long Distance		100						
- International		100						
Electricity prices[11]								
- Households	12.51	12.02	11.95	12.00	10.57	10.48	10.40	10.33
- Industry users	7.13	6.47	6.43	6.51	6.44	6.32	6.44	6.33
Market share electricity (%)[12]		58						
Education expenditure[7]	5.6	5.7			5.0	5.0	5.1	
New S&T graduates[13]			6.3					
R&D expenditure[7]		0.76			1.87	1.92	1.90	
Internet access at home[14]		4.0	18.1	23.4		12.0	28.4	36.1
Patent applications[15]	2.4	4.7	3.9		129.9	140.9	152.7	

Note: For footnotes and source see Table 1.4 for Belgium.

12.4.3 Capital markets

- **Overall assessment**

23. Consolidation in the banking sector continued in 2001, along with a growing integration of the Portuguese capital market. The presence of foreign banks increased. The Lisbon stock exchange is to merge with Euronext. The Portuguese venture capital market, already among the least developed in the EU, contracted noticeably in the first half of 2001.

24. In terms of supervision, the creation last year of the National Council of Financial Supervisors has strengthened co-ordination among the regulatory authorities. A draft decree law reviewing the legal framework of credit institutions and financial companies will enhance the framework for the conduct of prudential supervision and the scope of the supervisory powers of Banco de Portugal.

25. In terms of prudential legal framework, the minimum requirements for credit institutions and finance companies were reinforced and norms relating to payment systems, activities and the solvability ratio of credit institutions were transposed into the internal legal system. To prevent money laundering, the Bank of Portugal has issued a recommendation for financial institutions to examine the operations involving residents from so-called non-co-operative countries or territories. The transposition of the EU Directives regarding e-money institutions is underway.

26. In terms of regulatory framework, the autonomy and independence of the Insurance Institute of Portugal, has been reinforced.

27. Several measures were taken to improve consumer and investor protection. For instance regarding the contracts agreed at distance or at home and the compensation of the clients who have suffered damages as a result of delays in the regularisation of debits unduly made by responsible financial institutions (in line with the FSAP). The Regulation of the Investor Compensation System has also been approved.

28. Some progress was made in implementing the 2001 capital market recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendation in the 2001 BEPGs	*Degree of implementation*
➢ Develop further the risk capital market by easing constraints on institutional investment in equity capital, by establishing a fiscal framework more conducive to investment and entrepreneurship, the latter to be also encouraged by adjusting bankruptcy laws	In progress

29. Some structural reforms were implemented to stimulate the development of the risk capital market. To avoid double taxation, venture capital institutions have been allowed to deduct 100% of the profits from the participated companies; new incentives were granted to tax saving; tax benefits to R&D activities were increased and the new tax regime on securitised credit will reinforce enterprises' self-financing capacities. Several public funding initiatives are also supporting the development of venture capital (eg: Incentive System for Small Business Initiatives). However no measure was taken

regarding quantitative constraints on institutional investment and no real progress has been made in the adjustment of the bankruptcy laws.

13. FINLAND

13.1 Macroeconomic context

1. Growth in Finland slowed down sharply in 2001, ending seven years of buoyant economic activity. This was mainly the consequence of a sharp decline in exports, and weakened domestic demand and construction investment. Equipment investment held up better, while government consumption showed a strong rebound. Despite the marked slowdown of output growth, employment expanded still favourably for most of the year and unemployment continued to decline, although at a decelerating pace. Inflation eased markedly towards the end of the year, after having peaked at 3.3% in May, as both external and internal price-push factors subsided.

Table 13.1: **Economic developments in Finland**[1)]

	1992-97	1998	1999	2000	2001
Real GDP	2.2	5.3	4.1	5.6	0.5
Domestic demand	0.6	4.8	2.8	3.3	1.2
Private consumption	1.1	5.1	4.0	2.2	1.5
GFCF (Investment)	-1.6	9.3	3.0	4.8	1.8
Exports (G&S)	11.4	8.9	6.8	18.2	-2.6
Imports (G&S)	6.6	8.5	4.0	16.2	-2.2
Inflation [2)]	1.8	1.4	1.3	3.0	2.7
Compensation/employee	2.4	4.1	2.1	3.9	4.4

Note: For footnotes and sources see Table 1.1 for Belgium.

13.2 Key challenges

2. Whereas Finland made progress in implementing the recommendations of the 2001 BEPGs, a number of key policy issues require continued attention, in particular the high level of structural unemployment, the sustainability of the pension system, the low level of competition in certain sectors and the efficiency of the public sector.

Key economic policy challenges for Finland

- Reducing the high level of structural unemployment.
- Ensuring the sustainability of the pension system.
- Improving the low level of competition in certain sectors and the efficiency of the public sector.

3. Various estimates of NAIRU suggest that unemployment is predominantly structural, and the current downturn of the economy does not help to reduce it. Efforts have been made to better target and tailor ALMPs to the needs of the likely beneficiaries. There have also been efforts to help the inclusion of the most hard-to-place unemployed in the

labour market, combined with a tightened control of availability for work and increased financial incentives to participate in activation programmes. However, scheduled measures to increase unemployment benefits run contrary to the aim of increasing incentives to work.

4. The medium-term target of a structural surplus in central government finances is crucial, as Finland is one of the Member States most exposed to the effects of an ageing population. The present government is committed to reforms that increase the effective retirement age by 2-3 years in the long run. Several measures have recently been proposed to reform the private sector pension system. Proposals for pension reform, mainly to be implemented in 2005, include an overhaul of early retirement schemes and an increase in financial incentives to work longer. However, the late implementation of these proposals is a drawback. Moreover, the measure to replace the current unemployment pension scheme with the right to an extended unemployment benefit period will be implemented gradually only from 2007. The reforms to take into account the increased life expectancy and to modify the calculation of pensionable earnings on the basis of the whole career, which affect most of the future pension expenditure, have been postponed.

5. Finland has one of the highest price levels in the EU, 21% above the EU average. This is due to the combined effect of high living standards and taxes, a peripheral location, and insufficient competition in certain sectors. Recent investigations by the Competition Authority point to concerns about competition, particularly media, packaging and recycling. Despite some legislative changes aimed at resolving discriminatory tax rules, competition also remains limited in the area of public services, and the share of public procurement open to competition remains low.

13.3 Public finances

- **Overall assessment**

6. Due to the fading out of the factors behind the exceptional tax revenues in 2000 and also as a result of the sharp economic slowdown the general government budgetary surplus eased from its record height of 7.0% of GDP in 2000 to an estimated (but still strong) 4¾ % in 2001. Owing to the projected decrease in the budgetary surplus but also because of a portfolio diversification of social security institutions away from domestic government bonds, the pace of general government debt reduction is estimated to have markedly moderated in 2001, with the debt ratio ending up 1¼ percentage points lower at 42¾ % of GDP. According to the stability programme, annual expenditure ceilings will remain the key budgetary consolidation strategy. However, both in 2001 and 2002 these ceilings are likely to be exceeded; expenditure relative to GDP is projected to increase in 2002. In view of the budgetary cost of an ageing population, to which Finland is particularly exposed, the sustainability of government finances is being strengthened by ongoing reforms of the pensions system and the efforts to reduce government debt. The average retirement age in Finland remains very low which, if not corrected, will lead to expenditure pressures already before 2010.

7. Some progress was made in implementing the 2001 public finance recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendations in the 2001 BEPGs	*Degree of implementation*
➢ Adhere to the expenditure targets set in the budget for 2001.	No new measures
➢ Maintain high government surpluses in 2001 and the following years through a reduction in government expenditure relative to GDP.	Partial
➢ Ensure the long-term sustainability of public finances in view of the future effects of population ageing on pension and health care costs, to which Finland is particularly exposed; this requires the continuation of the policy of debt reduction but needs to be complemented by measures, to be adopted during the programme period, raising the low effective retirement age.	In progress

8. The target of the Finnish public finances has been to keep central government expenditure at the level of 1999 in real terms, with a view to creating a structural surplus in central government finances of the order of 1½ - 2 % of GDP. It appears that the medium-term spending ceilings are subject to an overshooting in both 2001 and 2002. The overrun should be seen in the context of the slowing economy and the additional margins created by the high surplus in 2001, but higher-than-planned expenditure was also due to discretionary spending increases in various areas of the budget.

9. Although significantly lower than in 2000, with 4¾ % of GDP the budget surplus in 2001 remained still very high. According to the stability programme update the surplus will decline further to some 2½ % of GDP in 2002 and the following years. Moreover, total expenditure in relation to GDP is projected to increase in 2002 followed by a moderate decrease in subsequent years. In comparison with the previous programme the new update projects expenditure relative to GDP to decline at a markedly lower pace.

10. According to the updated stability programme, the pace of reduction of government debt relative to GDP is significantly decelerating in coming years and the ratio will even rise in 2002 and 2003. Partially this is due to an ongoing reduction of domestic government bonds holdings of social security institutions, implying that the underlying improvement is stronger than shown by national accounts statistics. The average retirement age remains particularly low in Finland. In this regard, the agreed reform of the pension system makes an important step in the right direction but needs to be implemented before long.

Table 13.2: **Trends in public finances in Finland** [1]						
	1994	**1996**	**1998**	**1999**	**2000**	**2001**
Government balance	-5.7	-3.2	1.3	1.9	7.0*	4.8
- Total revenue	57.8	56.8	54.5	54.1	55.8	53.3
Tax burden [2]	47.6	47.4	46.6	46.8	47.6	46.6
- Total expenditure	63.4	59.9	53.2	52.2	48.9	48.5
Primary current expenditure	52.2	48.8	44.0	43.7	41.2	41.2
Interest payments	4.2	4.3	3.6	3.1	2.8	2.3
Investment	3.0	2.9	2.9	2.9	2.6	2.4
Primary balance	-1.5	1.1	4.9	5.0	9.7	7.0
Government debt	58.8	57.1	48.8	47.3	44.2	42.7
Cyclically-adjusted balance	-1.2	-0.7	0.1	0.2	3.7	3.4
Cyclically-adj. Primary balance	2.9	3.5	3.7	3.3	6.6	5.7

Note: For footnotes and source see Table 1.2 for Belgium.

13.4 Economic reforms

13.4.1 Labour markets

- **Overall assessment**

11. After outpacing the EU average for seven successive years up to 2001, employment growth is expected to cease in 2002. The female employment rate exceeds the corresponding Lisbon target and the overall employment rate the mid-term target for the EU as a whole. The employment rate for older workers has clearly improved in recent years and is above the EU average, but further efforts are still required to reach the EU target for 2010. The unemployment rate has decreased slowly in the past two years, leaving it at a high level and predominantly structural in nature.

12. Good progress has been made in implementing the 2001 labour market recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendations in the 2001 BEPGs	*Degree of implementation*
➢ Strengthen efforts to reduce high marginal effective tax rates especially on low wage earners and to improve incentives in benefit, especially pension, schemes to take up a job offer and to stay in the labour force.	In progress
➢ Increase the efficiency of active labour market programmes and refocus them to the needs of those most prone to the risk of long-term unemployment.	In progress

Table 13.3: **Labour market indicators for Finland**

	Finland					EU			USA		
	1990	1994	1999	2000	2001	1994	2000	2001	1994	2000	2001
Employment rate (ER) [1)]	74.4	60.4	66.4	67.3	:	59.6	63.2	:	72.0	74.1	:
Female ER [1)]	71.3	58.7	63.4	64.3	:	49.3	54.0	:	65.2	67.9	:
Older workers ER [1)]	42.2	33.4	39.0	42.0	:	35.7	37.7	:	54.4	57.7	:
Employment growth [2)]	-0.5	-1.1	2.7	1.8	1.4	-0.1	1.7	1.1	2.3	1.9	-0.1
ER full time equivalent	:	:	64.2	64.9	:	54.9	57.9	:	:	:	:
Unemployment rate (UR)	3.2	16.6	10.2	9.8	9.1	11.1	8.2	7.8	6.1	4.0	4.8
Long-term UR [1)]	1.2	6.1	3.0	2.8	:	5.2	3.6	:	:	:	:
Youth UR (<25)	9.3	34.0	21.4	21.3	19.7	22.1	16.2	15.5	12.4	9.3	10.6
Nominal wage growth [2)]	9.3	3.1	2.1	3.9	4.4	3.1	3.0	3.3	2.4	5.1	5.3
Real Unit Labour Cost growth [2)]	3.1	-3.9	0.9	-3.2	2.8	-2.4	-0.1	0.3	-1.1	0.7	1.8
Labour Productivity growth [2)]	0.6	5.1	1.2	3.9	-0.8	2.9	1.6	0.5	1.5	2.1	1.0
Tax rate on average wage earners [3)]	:	50.5	47.4	47.3	45.9	44.6	43.6	43.0	31.2	30.8	30.0
Tax rate on low wage earners[3)]	:	:	42.6	42.4	40.9	:	38.6	37.8	:	29.0	27.7
NRR on low income families (married) [4)]	:	87.0	83.0	:	:	72.0	67.0	:	59.0	59.0	:
NRR on low wage earners (single) [4)]	:	83.0	63.0	:	:	71.0	68.0	:	59.0	59.0	:

Note: For footnotes and sources see Table 1.3 for Belgium.

13. Tax reductions implemented in 2001 and 2002 continued the path of earlier, mainly proportional reductions, with a total real effect of 1.4% of GDP. The tax rates for low and medium wage earners have been reduced steadily at about the same pace. The main proposals for pension reform foresee a flexible retirement age, combined with an overhaul of early retirement schemes and an increase of financial incentives to work longer. However, the late implementation of reforms weakens their effect on the baby-boom generation and risks delaying the achievement of the government's objective of raising the effective retirement age. The current unemployment pension scheme will be replaced by the right to an extended unemployment benefit period starting from 2007, and applicable to persons born in 1950 or later. In addition, some eligibility rules will be somewhat loosened in 2003. The period of employment required to re-qualify for unemployment benefit will be shortened from 10 to 8 months and the conditions for the means-tested part-time unemployment benefit will be relaxed with the aim of making it more attractive for the unemployed to accept temporary and part-time jobs. However, measures are scheduled for 2002 that will increase the level of unemployment benefits.

14. The effectiveness of the ALMPs was not regarded as satisfactory in the 2001 National Employment Action Plan, and a number of measures were introduced in 2001 in order to improve their effectiveness, including: better targeting of programmes to those who are likely to benefit from them, better tailoring of programmes to individual needs, and better co-operation with employers at the planning stage of a programme. Moreover, measures aimed at preventing exclusion from the labour market have been introduced. They include, inter alia, better co-operation between social and labour administration, combined with a tightened eligibility control of availability for work, rehabilitative job

activities organised by the municipalities, and financial incentives, such as an activity increment and a travel grant, for those participating in a programme and taking up a job.

13.4.2 Product markets and the knowledge-based economy

- **Overall assessment**

15. Partly due to its peripheral situation, Finland is less exposed to trade than some other small Member States. Gains in productivity relative to the rest of EU seem to be stagnating and consumer price levels in Finland are among the highest in the European Union, which partly reflect the lack of competition in certain sectors. The time of registration of a new company remains among the highest in the Community and Finland has a lower propensity to advertise public procurement contracts than is the norm in the Union. However, the transposition deficit of the internal market directives is the lowest in the EU and telecommunication and electricity markets have been fully liberalised, which has contributed to lower prices in these sectors.

16. In the area of R&D, Finland is surpassed only by Sweden. More than 3.1% of Finnish GDP is used for R&D, and a thriving scientific community is generating high output too, as patenting in Finland runs two times higher than in the EU as a whole. Internet use is developing rapidly as close to half the Finnish households have access to the Internet. The government, too, is capitalising on the spread ICT, as 95% of all agencies offer web-enabled services.

17. Some progress was made in implementing the 2001 product market recommendations

- **Implementation of the 2001 BEPGs**

Country-specific recommendations in the 2001 BEPGs	*Degree of implementation*
➢ Enhance compliance with regulations in public procurement, especially at the local level, and increase transparency in the provision of public services in order to heighten private firms participation	In progress
➢ Enhance competition in industries such as distribution, construction, and the media sector	Partial

18. An electronic information exchange on public procurement was set up in 2001. But many other measures proposed by a working group set up by the Ministry of Finance have been prepared. However, the share of public procurement open to competition remains low. Open advertising would provide access to smaller contracts, which would otherwise fall below the threshold value above which advertising is mandatory. The Finnish government intends to address this issue at the latest in 2002, in connection with a reform in the legal provisions on public procurement. Some measures have been implemented to improve transparency in the provision of public services. Vouchers for some services have been introduced, but legal provisions, which are generally deemed unclear, often dampen incentives for local authorities to adopt their use. A revision of the VAT Act recently passed Parliament. This will introduce a mechanism by which public entities are compensated for the VAT paid on inputs for health care and social services produced by private providers, and will thus bring the tax treatment of private services in line with that of public services.

19. According to the national report on product and capital reforms, competition in retail distribution is described as being sufficient because of the presence of foreign companies in the market and because of the competition enhancing conditions attached to the decisions in several cases referred to the Finnish Competition Authority. In addition, competition within retail groups alleviates the anti-competitive effects arising from a concentrated market. Some measures aiming at enhancing competition in the construction sector have been taken. However, a series of competition cases referred to the Finnish Competition Authority indicates that market dominance concerns in the media industry are still valid.

Table 13.4: **Product market indicators for Finland**

	FINLAND				EU 15			
	1998	1999	2000	2001	1998	1999	2000	2001
Labour productivity[1]	101.4	100.2	102.1	100.8	100	100	100	100
Relative price levels[2]	118.0	120.0	121.0		100	100	100	
Total trade to GDP ratio (%)[3]	29.7	28.7	33.0	30.5	41.2	41.9	46.7	45.8
FDI share[4]	8.5	2.8	5.3		2.7	5.0	8.9	
Cross-border M&A share[5]	2.8(1.5)	3.3(1.5)	3.4(1.5)		100	100	100	
Single Market Directives[6]	0.9	1.7	1.3	0.7	3.9	3.6	3.0	2.0
Value of tenders in the O.J.[7]	1.5	1.6	2.0		1.8	1.8	2.4	
Sectoral and ad hoc State aids[8]	1.5	1.4			1.0	0.9		
Prices in telecommunications[9]								
- Local	0.21	0.21	0.22	0.23	0.41	0.41	0.41	0.41
- National	0.84	0.86	0.87	0.88	2.16	1.69	1.34	1.15
- Call to USA	7.43	5.65	5.68	4.80	5.07	4.09	3.39	2.65
Market share fixed telecom (%)[10]								
- Local		100	95.0					
- Long Distance		96.0	32.0					
- International		96.0	54.0					
Electricity prices[11]								
- Households	7.10	6.46	6.43	6.66	10.57	10.48	10.40	10.33
- Industry users	4.14	3.82	3.75	3.80	6.44	6.32	6.44	6.33
Market share electricity (%)[12]		26.0						
Education expenditure[7]	6.2	6.2	6.0		5.0	5.0	5.1	
New S&T graduates[13]	15.9	16.1	17.8					
R&D expenditure[7]	2.89	3.19			1.87	1.92	1.90	
Internet access at home[14]		21.0	43.5	48.1		12.0	28.4	36.1
Patent applications[15]	260.2	294.2	320.3		129.9	140.9	152.7	

Note: For footnotes and source see Table 1.4 for Belgium.

13.4.3 Capital markets

- **Overall assessment**

20. Measures have been taken to safeguard the stability of financial markets, inter alia by improving regulation and supervision. New rules on insider-trading based on a self-regulatory regime have been drawn up. The securities settlement system and service chain have been enhanced. The Government has submitted a proposal to amend several acts in relation to settlement of securities. The aim is to improve the functioning of securities markets by relaxing the provisions on the listing of securities, by reforming provisions related to trading counterparties and by simplifying the conditions for trading in securities and derivatives. Global developments related to financial instruments and their regulatory regime will be taken into account in these legislative reforms. The proposal is anticipated to come into force in early 2002. In addition to acquiring a 60 percent majority of shares in the Tallinn Stock Exchange, the Helsinki Stock Exchange has recently signed a cross membership and cross trading agreement with Euronext.

21. A Government Proposal related to the supervision of financial conglomerates was submitted to Parliament in October 2001. The aim is to make the supervision of financial conglomerates clearer and more effective and to improve the operations of such conglomerates. Further reforms are also underway concerning the right of non-financial companies to accept deposit funds and competition among statutory earnings-related pension schemes. Two working groups, whose terms end on 31 October 2002, have been set up to review the tax regime. The expert group established by the Ministry of Finance is focusing on income and property tax, and in particular on corporate and capital income taxes. Another group established by the Prime Minister's Office will assess the reform needs in taxation in a wider macroeconomic context.

22. Consolidation has continued in the financial system in Finland. A financial conglomerate (Sampo) consisting of Finland's largest insurance company and Finland's third largest bank was established at the beginning of 2001, where bank, investment and insurance operations were all placed in a joint holding company. The consolidation process has a Nordic dimension. After the attempted takeover of the Norwegian insurance company Storebrad failed, Sampo's non-life insurance operations have been transferred to the Nordic insurance company If.

23. The capital market sector managed capital for a total of EUR 2,2 billion at the end of 2000. Altogether, EUR 400 million was transferred from funds to enterprises in the course of last year. The volume of capital invested was up by almost 40% in relation to the previous year. With initial public offerings decreasing, the main focus in capital investment has shifted to investing in enterprises in the seed and start-up stages. Insurance companies and pension institutions are among the largest investors, but new capital is also derived from outside Finland. Foreign investors have begun to show greater interest in companies in their seed and start-up stages. In 2000, Finland's total inward foreign direct investment flows were greater than Finland's outward investment flows.

24. Some progress was made in implementing the 2001 capital market recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendation in the 2001 BEPGs	*Degree of implementation*
➢ Develop further the risk capital market by adapting the fiscal framework to make it more conducive to investment and entrepreneurship.	In progress

25. Legal provisions on capital guarantees provided by the Finnish Export and Guarantee Credit Agency, which serve as a guarantee for investors in case of investor losses on venture capital investment, came into force on 1 September 2001. No government aid is involved in these activities. Capital guarantees and the refocusing of capital investment toward enterprises in the seed and start up stage capital guarantees should support Finland's already comparably developed risk capital market. In addition tax reforms to stimulate growth and investment are currently under discussion.

14. SWEDEN

14.1 Macroeconomic context

1. Economic growth slowed down substantially in 2001 compared to the high growth rate in 2000. This was mostly due to the continuing effect of adverse economic shocks, and particularly related to the global slump in the telecom sector. External demand is expected to pick up during 2002 and domestic demand, in particular private consumption should regain some strength over the year, aided by an increase in disposable income. The labour market continued to develop favourably in 2001. However, employment growth was less buoyant and a stabilisation of the unemployment rate was observed towards the end of 2001. Nevertheless, a slight increase in unemployment, in line with the subdued growth prospects of the economy, is expected. The strong employment growth together with weak GDP growth resulted in poor productivity performance in 2001. Wage increases were moderated, and are likely to remain so. HICP inflation averaged 2.7% in 2001. It rose sharply in spring and has remained relatively high since then, partly due to temporary factors.

Table 14.1: **Economic developments in Sweden**[1)]

	1992-97	1998	1999	2000	2001
Real GDP	1.2	3.6	4.5	3.6	1.4
Domestic demand	-0.1	4.3	3.5	3.5	1.0
Private consumption	0.2	2.7	3.9	4.6*	0.9
GFCF (Investment)	-1.9	8.5	9.6	5.0	3.2
Exports (G&S)	8.7	8.4	6.5	10.3	-0.1
Imports (G&S)	5.5	11.2	4.4	10.3*	-1.1
Inflation [2)]	2.4	1.0	0.6	1.3	2.7
Compensation/employee	4.4	3.3	1.3	7.1	3.8

Note: For footnotes and sources see Table 1.1 for Belgium.

14.2 Key challenges

2. Whereas Sweden made progress in implementing the recommendations of the 2001 BEPGs, a number of key policy issues require continued attention, in particular the incentives to work, save or invest, the labour supply in the medium term, the level of competition in certain sectors and the efficiency of the public sector.

Key economic policy challenges for Sweden

- Strengthening the incentives to work, save or invest in order to raise productivity.
- Ensuring an adequate labour supply in the medium term.
- Improving the low level of competition in certain sectors and the efficiency of the public sector.

3. Policies that strengthen entrepreneurship and growth of firms, as well as the competitiveness of businesses and regions, are important to achieve robust and sustainable economic growth. Moreover, strengthening the financial incentives to work for certain groups, while improved in recent years, remains an issue. Sweden faces several challenges as regards raising productivity per person, which has fallen in recent years compared with the EU-15 average. The complex regulatory framework and the incentive structure arising from the tax and benefit systems are obstacles to strengthening the growth of firms, reducing regional dispersion and raising take-home pay for certain groups. While the government has based its better regulation policy on a small business' perspective, efforts to improve incentives in tax and benefit systems should be given high priority.

4. Employment rates remain very high, in particular for older workers (65% in 2000 compared to 38% for EU-15), indicating a limited "labour reserve" to draw upon in the medium term. A high tax burden, especially on low-wage earners, in combination with a compressed wage structure and relatively generous benefit schemes, reduce the incentives to take up a job or increase the number of hours worked. The government has traditionally put a great emphasis on education, training and life-long learning, but various evaluations have questioned the effectiveness of some types of programmes, raising concerns about the adaptability of the work force.

5. Sweden has the highest price level in the EU, more than 25% above the EU average. Apart from the modest external pressure due to its geographical location, competitive shortcomings are consistently found in various sectors, in particular, pharmaceuticals, food retailing, and construction. And although Sweden has the third-highest rate of openly advertised public procurement, at 3.7% of GDP in 2001, a recent study has revealed that many public units fail to comply with existing regulations. A similarly mixed pattern is found in the area of public services provision. Public operators are starting to concede market shares, but private operators still only represent an 8% share of employment in welfare services.

14.3 Public finances

- **Overall assessment**

6. The general government balance has been in surplus since 1998 and a large surplus is expected in 2001. The latest update of the convergence programme estimates continued surpluses of more than 2 per cent of GDP in the period 2002-2004 on unchanged policies. The strategy of lowering the tax burden is maintained and tax cuts were introduced in the budget for 2002. The fiscal rule of a budget surplus of 2 per cent of GDP on average over the business cycle is maintained. This strategy should result in further debt reduction and lower interest payments. This debt reduction is welcome and forms an important part of Sweden's long-term fiscal policy in order to face the budgetary pressures of ageing populations.

7. The 2001 updated convergence programme includes projections for the public finances until 2004. The budget surpluses foreseen in the 2001 update appear somewhat optimistic, particularly for 2002. This is linked to the fact that the macroeconomic scenario in the 2001 update foresees relatively high economic growth in 2001 and a significant recovery in 2002. The Commission has taken the view that economic growth should be relatively subdued in 2002 and result in a lower budget surplus that year.

Nevertheless, if economic growth should be lower and result in lower surpluses than foreseen by the 2001 update, as suggested by the Commission's autumn 2001 forecast, it can be concluded that Sweden continues to fully respect the Stability and Growth Pact's requirement for public finances of a fiscal position 'close to balance or in surplus'.

8. Good progress was made in implementing the 2001 public finance recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendations in the 2001 BEPGs	*Degree of implementation*
➢ Maintain high government surpluses in 2001 and beyond.	2
➢ Continue with the strategy of lowering taxes for low and medium wage earners in 2002 while still attaining the medium-term surplus target of 2 per cent of GDP, taking into account the position in the business-cycle, and at the same time ensure adherence to the central government expenditure ceiling.	2
➢ Pursue the strategy of reducing public debt in the medium-term, as described in the 2000 updated convergence programme, by maintaining the government surplus target of 2 per cent of GDP over the cycle while implementing the strategy of further tax cuts and tight expenditure control. This should place Sweden in a better position to cope with the burden on public finances stemming from the ageing of the population.	2

9. A strong surplus in the government finances, of almost 4 per cent of GDP, is expected in 2001. This results from continued expenditure restraint and buoyant tax revenues, influenced by strong carry-over effects from the previous year. Moreover, relatively strong labour market developments in 2001 also contributed to contain expenditure and to boost tax revenue. However, economic growth was weak in 2001 and is expected to improve only marginally in 2002. This is expected to result in a lower surplus in 2002, of 1.6 per cent of GDP. A further recovery is foreseen for 2003 and a higher surplus in the public finances is expected, close to the medium-term target of 2 per cent of GDP.

10. The strategy of lowering the tax burden further is maintained and a third tranche of tax cuts, corresponding to 1.1 per cent of GDP, was introduced in the budget for 2002. Conditional on an assessment of the position in the business cycle and of the inflationary pressures, decisions on further tax cuts (if any) will be taken according to the national budgetary process. The expenditure ceiling on central government is likely to have been respected in 2001 and the government remains firmly committed to ensure adherence to the ceilings set for 2002 and beyond. However, the contingency reserves for 2002-2004 incorporated in the ceilings were narrowed further in the budget for 2002. If economic growth should be weaker than expected, some measures to contain expenditure may be necessary. While the expenditure ceilings applies to total spending, it is important to contain expenditure over-runs in all areas, in order to maintain the use of expenditure ceilings as a credible tool for multi-annual budgetary planning.

11. Sweden maintains the 2 per cent of GDP surplus target for public finances over the cycle. This should enable further reduction of the debt-to-GDP ratio, which fell below 60 per cent in 2000, and a further lowering of interest payments. The debt-to-GDP ratio

is expected to fall below 50 per cent in 2003. The 2001 updated convergence programme notes that continued debt reduction is an important element of Sweden's strategy of coping with the budgetary pressures on public finances stemming from ageing populations. The use of expenditure ceilings for central government has been instrumental in strengthening the credibility of sound public finances since they were introduced in 1997. It is therefore important to firmly continue this procedure of expenditure control in an environment where economic growth is relatively subdued. The strategy of lowering taxes has been extended to 2002, with an emphasis on reducing income tax. However, the continuing globalisation of the economy implies new challenges for welfare states with relatively large public sectors. Different tax bases are differently affected by the development and the possibility of tax base erosion as well as the need for Sweden to remain competitive must be seriously considered, as recognised in the 2001 updated convergence programme. In this context, the overall impact of the tax and benefit systems on households disposable income and the marginal effects arising from these should therefore be considered explicitly in reforming the incentive structure for people to work and to conduct business.

Table 14.2: **Trends in public finances in Sweden** [1)]

	1994	1996	1998	1999	2000	2001
Government balance [2)]	-10.8	-3.1	2.1	1.3	3.8	3.9*
- Total revenue	59.9	62.2	62.9	61.8	61.7	60.8
Tax burden [3)]	47.3	51.3	53.1	52.7	53.1	52.6
- Total expenditure	70.7	65.3	60.8	60.1	57.7	57.0
Primary current expenditure	56.3	52.5	50.3	49.4	48.1	48.3
Interest payments	6.6	6.8	5.7	5.0	4.2	3.5
Investment	3.5	3.0	2.7	2.8	2.5	2.5
Primary balance [2)]	-4.3	3.7	7.7	6.3	8.0	7.4
Government debt	77.7	76.0	70.5	65.0	55.3	52.3
Cyclically-adjusted balance [4)]	-9.1	-1.9	2.5	0.8	2.4	3.0
Cyclically-adj. primary balance [4)]	-2.5	4.9	8.2	5.8	6.7	6.5

Note: For footnotes and source see Table 1.2 for Belgium.

14.4 Economic reforms

14.4.1 Labour markets

- **Overall assessment**

12. Sweden has one of the best-performing labour markets in the EU in terms of employment rates, particularly for women and older workers. The employment rate of older workers (55-64 years old), at around 65% in 2000, is markedly higher than in other Member States. Unemployment stabilised at just over 5% of the labour force in 2001. However, the tax burden on labour remains one of the highest in the EU, in particular for low wage earners, and benefit levels are relatively high, but with comparatively strict eligibility criteria.

13. Good progress was made in implementing the 2001 labour market recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendations in the 2001 BEPGs	*Degree of implementation*
➢ Pursue reforms of tax and benefit systems to promote work incentives and, in particular, reduce the tax burden for low wage earners; and	In progress
➢ Ensure the efficiency of the ALMPs and target them at those most prone to the risk of long-term unemployment, as well as to meet the demands of the labour market	2

14. A number of measures have reduced the tax burden on labour in 2001, and further cuts have been introduced and/or are planned for this year (amounting to almost 1% of GDP per year). In short, the individual contributions to the pensions systems are further compensated by 25%, amounting to 75% altogether in 2002; a tax relief has been introduced for pensioners; trade union fees have been granted a tax reduction corresponding to 25% of the total fee; and the basic tax allowance has been further increased. In addition, social security contributions have been reduced by an additional 10% of the wage bill, up to SEK 852.000 for employers in certain development areas (above all in the northern parts of Sweden). It appears as if the tax cuts are general in nature or targeted towards middle and low-income earners. Furthermore, the benefit levels (in unemployment insurance) for the first 100 days of unemployment have been raised in 2002 (i.e. an increased threshold of the income level). However, after the first 100 days of unemployment, the ceiling of the benefit level is reduced and the job seeker will be required to accept both occupational and geographic mobility, which should increase incentives to take up a job. Further improvements are also announced for 2003 in the sickness- and parental- insurance schemes.

Table 14.3: **Labour market indicators for Sweden**

	Sweden					EU			USA		
	1990	**1994**	**1999**	**2000**	**2001**	**1994**	**2000**	**2001**	**1994**	**2000**	**2001**
Employment rate (ER) 1)	80.0	69.2	70.1	70.8	:	59.6	63.2	:	72.0	74.1	:
Female ER 1)	78.7	69.1	68.4	69.3	:	49.3	54.0	:	65.2	67.9	:
Older workers ER 1)	70.2	62.4	64.5	64.7	:	35.7	37.7	:	54.4	57.7	:
Employment growth 2)	0.9	-0.8	2.3	2.2	1.8	-0.1	1.7	1.1	2.3	1.9	-0.1
ER full time equivalent	:	:	63.8	65.1	:	54.9	57.9	:	:	:	:
Unemployment rate (UR)	1.7	9.4	7.2	5.9	5.1	11.1	8.2	7.8	6.1	4.0	4.8
Long-term UR 1)	0.1	2.5	2.2	1.7	:	5.2	3.6	:	:	:	:
Youth UR (<25)	4.4	22.0	13.6	11.3	11.1	22.1	16.2	15.5	12.4	9.3	10.6
Nominal wage growth 2) *	11.3	4.8	1.3	8.7	3.8	3.1	3.0	3.3	2.4	5.1	5.3
Real Unit Labour Cost growth 2) *	1.8	-2.4	-1.5	6.1	2.3	-2.4	-0.1	0.3	-1.1	0.7	1.8
Labour Productivity growth 2)	0.4	4.9	2.1	1.4	-0.4	2.9	1.6	0.5	1.5	2.1	1.0
Tax rate on average wage earners 3)	:	46.8	50.5	49.5	48.6	44.6	43.6	43.0	31.2	30.8	30.0
Tax rate on low wage earners3)	:	:	48.7	47.9	47.0	:	38.6	37.8	:	29.0	27.7
NRR on low income families (married) 4)	:	85.0	82.0	:	:	72.0	67.0	:	59.0	59.0	:
NRR on low wage earners (single) 4)	:	78.0	82.0	:	:	71.0	68.0	:	59.0	59.0	:

* Based on ESA95 national accounts, compensation of employees (D1). By including *all* labour costs, nominal wage growth was around 4% and real unit labour costs slightly above 2% in both 1999 and 2000.

Note: For other footnotes and sources see Table 1.3 for Belgium.

15. The government established an independent public authority, the Office for Labour Market Evaluations (IFAU) in 1997, which carries out rigorous evaluations of ALMPs. The evaluations suggest that some programmes seem to work better than others, and for some sub-groups of the labour market more than others[8]. In response to the outcome of these evaluations, as well as to the changed labour market situation, the government: has reduced the number of participants in ALMPs (down from more than 5% of the labour force in the mid 1990s to 2½% in 2001); has more closely targeted them to persons with a weak position in the labour market; and has changed the mix of programs. For instance, it has markedly reduced and improved the targeting of traditional labour market programmes (AMU) in recent years, and abolished some of the large-scale (youth) training programmes (e.g. UP) or centrally organised work experience scheme (ALU). It has also changed the mix of the remaining programmes, strengthening the use of e.g. individual counselling and support to employers hiring a

8 It appears as if programmes provided by an enterprise, whether work experience or training, are more efficient than classroom vocational training for the participants. Participants in employment subsidy programmes have the most positive employment prospects, but these programmes also create substantial displacement effects (of around 2/3). There seems to be no such crowding-out effects from training programmes. Business start-ups (or self-employment grants) seem more efficient than general employment subsidies (at least for Swedish citizens). Improving the situation for young people has appeared particularly difficult. The evaluation of youth programmes suggested a zero or negative effect on both employment and earning prospects, as well as on the probability of being in regular education after a year, even if these effects diminish over time.

long-term unemployed person. In addition, further results concerning the effectiveness of ALMPs are expected during this year with the impact evaluation of the European Employment Strategy.

14.4.2 Product markets and the knowledge-based economy

- **Overall assessment**

16. Sweden's economy is less open (as measured by the total trade-to-GDP ratio) than the average for smaller EU economies despite improving since the mid-1990s. The degree of implementation of the Internal Market directives is among the highest in the EU. Sweden is the third-most eager advertiser of public procurement, at 3.7% of GDP in 2001. Nevertheless, compared to many other Member States, the relative size of the public sector is large. Partly due to a lack of competition in certain sectors, price levels remain high and labour productivity is below the EU average. The market for telecom services has showed remarkable progress mainly due to early liberalisation. Prices on phone calls are well below the EU average, and national calls are particularly cheap. Notwithstanding this progress, the state-owned incumbent still has a dominant position in the market, in particular for local and long distance. Energy markets are relatively open to competition with 100% market opening for electricity and 50% for natural gas.

17. Spending on R&D is the highest in the EU. Notably, Sweden has a balanced distribution of R&D efforts, with industry accounting for around three quarters. The uptake of ICTs is among the highest in the EU: more than 75% of households are equipped with a computer, 64% have Internet access, and almost 75% of the working population are using a computer at work. Enthusiasm about the technology is trickling down to school levels too, where there is one Internet-enabled computer for every 9 pupils.

18. Limited progress was made in implementing the 2001 product market recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendations in the 2001 BEPGs	*Degree of implementation*
➢ Enhance compliance with regulations on public procurement and enhance competition in public services provision at local levels	In progress
➢ Increase competition in areas such as air transport and pharmaceuticals	No new measures

19. The general perception is that complex regulations account for many of the compliance problems. In response to this, the Public Procurement Committee has launched new work on simplifying the rules. On public services provision, the Government is seeking to resolve growing friction between public and private providers. A governmental committee has presented proposals including a dispute resolution system and appointment to the Market Court of an expert on public services provision. The Government intends to reach a decision on the proposals in spring 2002. Finally, a database on municipal activities seems to be in the offing. This will enable users to benchmark municipalities on the quality, volume, and resources spent in providing services.

20. In domestic air transport, SAS continues to dominate. This dominance may however diminish under the impact of a recent court decision, which bans the company's use of its frequent-flyer program on certain domestic routes. The Civil Aviation Administration will continue to monitor the market situation and in November 2001 presented an analysis of the degree of competition in domestic air transport to the government, including some suggestions for improvement. In the retail market for pharmaceutical products, the Government is clinging to its decision to uphold the state-owned monopoly. In order to mitigate the consequences for prices, new rules for controlling subsidisation and provisions to exchange drugs when a less expensive replacement is available are envisaged, but not yet implemented. In addition, a new independent authority is on the drawing board to reinforce public oversight.

Table 14.4: **Product market indicators for Sweden**

	SWEDEN				**EU 15**			
	1998	1999	2000	2001	1998	1999	2000	2001
Labour productivity[1]	93.8	93.0	92.9	91.1	100	100	100	100
Relative price levels[2]	122.0	125.0	128.0		100	100	100	
Total trade to GDP ratio (%)[3]	32.0	31.8	35.1	33.2	41.2	41.9	46.7	45.8
FDI share[4]	6.7	24.4			2.7	5.0	8.9	
Cross-border M&A share[5]	5.9(3.0)	7.6(2.8)	6.3(2.9)		100	100	100	
Single Market Directives[6]	1.5	2.1	1.2	0.9	3.9	3.6	3.0	2.0
Value of tenders in the O.J.[7]	2.5	2.7	3.7		1.8	1.8	2.4	
Sectoral and ad hoc State aids[8]	0.7	0.6			1.0	0.9		
Prices in telecommunications[9]								
- Local	0.29	0.29	0.30	0.30	0.41	0.41	0.41	0.41
- National	0.58	0.45	0.30	0.30	2.16	1.69	1.34	1.15
- Call to USA	4.90	4.90	1.11	1.11	5.07	4.09	3.39	2.65
Market share fixed telecom (%)[10]								
- Local		93.0	82.0					
- Long Distance		76.0	82.0					
- International		62.0	59.0					
Electricity prices[11]								
- Households	7.01	6.22	6.52	6.84	10.57	10.48	10.40	10.33
- Industry users	3.68	3.51	3.88	3.75	6.44	6.32	6.44	6.33
Market share electricity (%)[12]		53.0						
Education expenditure[7]	8.0	7.7	8.4	8.3	5.0	5.0	5.1	
New S&T graduates[13]	7.9	9.7	11.6					
R&D expenditure[7]	3.75	3.80			1.87	1.92	1.90	
Internet access at home[14]		51.0	53.8	64.3		12.0	28.4	36.1
Patent applications[15]	307.0	308.5	346.4		129.9	140.9	152.7	

Note: For footnotes and source see Table 1.4 for Belgium.

14.4.3 Capital markets

- **Overall assessment**

21. The financial sector in Sweden has been characterised by continued banking sector transformation, legislative and taxation reform and technological development. A number of legislative initiatives were taken in 2001 to improve conditions in the securities markets. Legislation was introduced to improve the conditions for securitisation and a proposal was put forward to allow mortgage institutions to issue secured bonds.

22. The government's work on improving business and capital taxation is in progress. In the 2002 Budget Bill, the government proposed that the imputed income for investment firms is lowered from 2% to 1.5% in order to create neutrality between these firms and mutual funds. In 1999, the government appointed two commissions to review the tax regulations governing dividends and capital gains with the aim of stimulating growth and investment in Swedish companies, as well as considering how to facilitate generation changes in family-run companies. In 2001, a report was submitted by one of the commissions proposing that capital gains on business-related shares should be largely tax-exempt. Due to the complexity of the issues, a bill will not be presented to the Parliament until spring 2002. Also, proposals were made that would make Swedish bankruptcy law more geared towards reconstruction of companies.

23. The Financial Supervisory Authority (FSA) is developing a refined internal risk assessment system. The co-operation agreement signed in 2000 with its counterparts in Denmark, Finland and Norway was broadened during 2001. The transformation of the banking system continued in 2001 with new players receiving permits to establish banking business. Also, two large retail-chains announced plans to offer banking services to their customers. Swedish banks continue to focus strongly on "home banking", with the use of the Internet as a central feature.

24. The venture capital market grew to record levels during 2000. The difficult situation in the stock market has, however, seriously hampered development market development in 2001. The bulk of the increase in 2000 was related to investments in mature companies. Investment in the seed and start-up phases fell as a share of total investment in unlisted shares, but rose in absolute terms. Unlike the pattern observed in most EU Member States, investment activity continued in the first three quarters of 2001, albeit at a decreasing rate. The investment during this period was in the seed and start-up phases as well as the expansion stage.

25. Some progress was made in implementing the 2001 capital market recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendation in the 2001 BEPGs	*Degree of implementation*
➢ Develop further the risk capital market by adapting the fiscal framework to make it more conducive to investment and entrepreneurship bankruptcy laws.	In progress

26. Sweden has already a relatively well-developed risk capital market. During 2001, progress has been made in improving bankruptcy legislation to encourage reconstruction of failing companies. Also, proposals have been made to reduce corporate taxation to stimulate growth and investment.

15. UNITED KINGDOM

15.1 Macroeconomic context

1. The macro-economic performance combined low inflation, sound public finances and steady growth for a number of years. A platform of stability has been achieved by recent policies. The economy grew at a slower rate in 2001 than the 3% of the previous year, partly as a result of worsened international conditions. Nevertheless, for the year as a whole, growth was little below the trend growth rate of 2½%. Household consumption contributed strongly to growth, but export growth was low as a result of the global slowdown. Employment growth was reflected in a further decrease in the already low level of unemployment though this has bottomed out in recent months at a rate slightly above 5%. HICP inflation, at 1.0% in December, was close to the lowest in the EU. Subdued actual and prospective inflation, and the prospects of a much slower world growth than expected, resulted in cuts in the interest rate totalling a full two percentage points during 2001. Wage growth remains moderate despite the strong labour market.

Table 15.1: **Economic developments in United Kingdom**[1)]

	1992-97	1998	1999	2000	2001
Real GDP	2.7	3.0	2.1	3.0*	2.3
Domestic demand	2.6	5.1	3.4	3.6*	3.0
Private consumption	2.8	3.8	4.2	4.1*	3.8
GFCF (Investment)	3.1	13.2	0.9	4.9	2.0
Exports (G&S)	7.2	3.0	5.4	10.3*	2.1
Imports (G&S)	6.7	9.6	8.9	10.9*	3.7
Inflation [2)]	2.6	1.6	1.3	0.8	1.3
Compensation/employee	3.9	5.0	5.3	4.2*	4.3

Note: For Footnotes and sources see Table 1.1 for Belgium.

15.2 Key challenges

2. Whereas the United Kingdom made progress in implementing the recommendations of the 2001 BEPGs, a number of key policy issues require continued attention, in particular the relatively low level of productivity, the high concentration of unemployment to certain communities and the quality of public transport services.

Key economic policy challenges for United Kingdom

- Improving the relatively low level of productivity.
- Alleviating the high concentration of unemployment in certain communities.
- Improving the quality of services of public interest, notably in the transport sector.

3. The relatively low level of productivity remains a key challenge. Productivity per person employed was still 4% below the EU average in 2001 although the gap has been declining since 1995. Raising productivity requires further structural reforms across the whole economy and the Government itself has identified five priority areas of strengthening competition, promoting enterprise and innovation, improving the skills base, encouraging investment in physical capital and raising public sector productivity.

4. As far as the labour market is concerned, the key challenge remains the high concentration of unemployment and inactivity in certain communities. Although unemployment has fallen in all main regions, regional unemployment disparities have continued to rise. Moreover, while unemployment has fallen to around 5%, a further 9% of the working-age population claims sickness and disability or social assistance benefits. At the local level, there are areas throughout the country where more than 20% of the working-age population are out of work and claiming benefits.

5. The third key challenge is to improve the quality of its public services, notably in the transport sector. The Government has budgeted for a large increase in expenditure on public services, for example public net investment is expected to double from 2000-01 to around 1½% of GDP by 2002-03. However the Government needs to accompany the increase in expenditure by measures to use and allocate resources efficiently to ensure that consumers receive higher quality public services and that both consumers and taxpayers receive best value for money. In the transport sector particular challenges include creating a new railway infrastructure company and improving co-ordination between the private companies, independent regulators and public authorities involved in running the railways.

15.3 Public finances

- **Overall assessment**

6. The government balance was in surplus of 1 per cent of GDP in 2001. The convergence programme update contains budgetary projections showing the public finances moving into a small deficit this financial year, 2001-02, and a deficit that is at, or a little above, 1% of GDP for each financial year, from 2002-03, to 2006-07. The movement of the finances into deficit (and sustained deficit of around 1% of GDP) is advanced by one year, compared to the previous update; largely as a result of temporary economic factors (e.g. a lower level of GDP than previously projected, and lower financial company profits).

7. The update includes projections on the cyclically adjusted government balance which are little different from the unadjusted balance because the growth assumptions imply an economy close to potential throughout the programme period. The projections are made, for public finance purposes, on a cautious trend growth assumption of 2¼%. In practice the finances may turn out stronger than projected in the convergence programme because the projections are stronger under a central trend GDP growth assumption of 2½%. The public finances appear to be sustainable given the low, and falling, government debt to GDP ratio. The deficit, in the medium term, largely emerges as a result of addressing the very low level of public sector investment, which is close to the lowest in the EU.

8. Some progress was made in implementing the 2001 public finance recommendations.

- **Implementation of the 2001 BEPG**

Country-specific recommendations in the 2001 BEPGs	*Degree of implementation*
➢ Ensure that a general government surplus of at least 0.5 per cent of GDP is achieved in 2001-02 as projected in the 2001 budget.	In progress
➢ For the general government balance, ensure, in preparing the budget, that an out-turn in 2002-03 is achieved that, as planned, is close to balance.	In progress
➢ Allow public investment, net of depreciation, to double, as planned, as a share of GDP, between 2000-01 and 2003-04 while, at the same time, ensuring that the terms of the Stability and Growth Pact continue to be respected.	Partial

9. The out-turn in 2001-02 is expected, in the convergence programme update, to show a small deficit rather than the 0.5% of GDP surplus projected in the budget and referred to in the 2001 BEPGs. The deficit emerges as a result of temporary economic factors (e.g. a lower level of GDP than previously projected, and lower financial company profits). If it were not for these, the BEPGs recommendation for 2001-02 would be achieved. Further, a deficit, as projected in 2001-02 may not be realised. In particular, it may too cautious to assume the extent of the deterioration from the 1% of GDP surplus already recorded for calendar 2001.

10. The balance for 2002-03 is projected, by the authorities, to show a 1.1% of GDP deficit which is weaker than the very near to balance, 0.1%, of the previous update. Again, this is largely associated with a persistence of the temporary factors that contribute to weakness in 2001-02.

11. The government, in its first Comprehensive Spending Review, provided for a doubling of net government investment, as a share of GDP, between 1998-99 and 2001-02. The second Review made additional resources available to investment. The share is now shown, in the convergence programme update, to have risen from 0.4% of GDP in 1999-00, to 0.7% in 2000-01 and to rise further to 1.3% in 2001-02 and to 1.8% of GDP in 2004-05. In gross terms, which includes depreciation, the share relative to GDP is a higher level. Progress has been made, and the challenge will be for the government to achieve its medium-term plans. Nevertheless, in terms of the convergence programme's projections, albeit based on a cautious trend growth of 2¼%, the investment plans would be largely responsible for the deficit of around 1% of GDP that persists from 2002-03 to 2006-07.

Table 15.2: **Trends in public finances in United Kingdom**[1)]

	1994	1996	1998	1999	2000	2001
Government balance [2)]	-6.7	-4.4	0.4	1.1	4.3	1.2
- Total revenue	39.2	39.4	40.8	40.8	41.5	41.6
Tax burden [3)]	35	35.6	37.5	37.7	38.4*	38.3
- Total expenditure	46	43.8	40.4	39.6	37.2*	40.4
Primary current expenditure	38.3	36.9	34.3	34.6	34.7	35.1
Interest payments	3.4	3.7	3.6	2.9	2.9	2.5
Investment	2.1	1.5	1.2	1.1	1.2	1.5
Primary balance [2)]	-3.4	-0.7	4	4.1	7.1	3.8
Government debt	49.6	52.3	47.6	45.2	42.3*	39.3
Cyclically-adjusted balance [4)]	-6.3	-4.2	0	1	1.5	1
Cyclically-adj. primary balance [4)]	-3	-0.6	3.6	3.9	4.4	3.5

Note: For footnotes and source see Table 1.2 for Belgium.

15.4 Economic reforms

15.4.1 Labour markets

- **Overall assessment**

12. The UK has one of the best-performing labour markets in the EU in terms of employment rates, and unemployment and long-term unemployment are close to their lowest levels in two decades. However, the number of inactive people claiming benefits is relatively high, and local concentrations of unemployment and inactivity remain a concern.

13. Good progress was made in implementing the 2001 labour market recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendation in the 2001 BEPGs	*Degree of implementation*
➢ Reinforce active measures targeted at those communities and individuals most prone to the risk of concentrated or long-term unemployment and inactivity, and reform passive benefit schemes to provide people who are able to work with the opportunities and incentives to do so.	In progress

14. Efforts to tackle concentrated and long-term unemployment and inactivity continue. The range of active measures has been maintained and reinforced in certain respects (small amounts of extra funds for the Job Transition Service, extension of the New Deal for Lone Parents, extra funds for child care in disadvantaged areas). However, elements of the strategy remain at the 'pilot' stage, and it may be questioned whether the overall approach is sufficient to meet the Government's stated goal of full employment in every region and its vision that, within 10 to 20 years, no-one should be disadvantaged by where they live (2001 pre-budget report). The Government does not see the need to

reduce the threshold for the New Deal for long-term unemployed adults from 18 months to 12 months, arguing that this would not be cost-effective, and that active support is provided by the Jobseekers Allowance before the New Deal takes effect. As regards inactivity, the merging of the Employment Service with services of the Benefits Agency dealing with working-age people is a significant step. The reform of incapacity benefit, allowing claimants to try a small amount of work without losing benefit entitlement, is also of note.

Table 15.3: **Labour market indicators for the United Kingdom**

	UK					EU			USA		
	1990	**1994**	**1999**	**2000**	**2001**	**1994**	**2000**	**2001**	**1994**	**2000**	**2001**
Employment rate (ER) [1)]	:	68.1	71.0	71.5	:	59.6	63.2	:	72.0	74.1	:
Female ER [1)]	:	61.5	64.2	64.8	:	49.3	54.0	:	65.2	67.9	:
Older workers ER [1)]	:	47.5	49.6	50.8	:	35.7	37.7	:	54.4	57.7	:
Employment growth [2)]	1.2	0.7	1.1	1.0	0.7	-0.1	1.7	1.1	2.3	1.9	-0.1
ER full time equivalent	:	58.7	61.2	61.7	:	54.9	57.9	:	:	:	:
Unemployment rate (UR)	7.0	9.6	6.1	5.5	5.1	11.1	8.2	7.8	6.1	4.0	4.8
Long-term UR [1)]	:	4.2	1.7	1.5	:	5.2	3.6	:	:	:	:
Youth UR (<25) *	10.8	17.0	13.2	12.7	12.2	22.1	16.2	15.5	12.4	9.3	10.6
Nominal wage growth [2)]	9.2	2.9	5.3	4.1	4.3	3.1	3.0	3.3	2.4	5.1	5.3
Real Unit Labour Cost growth [2)]	1.9	-2.2	1.5	0.4	0.2	-2.4	-0.1	0.3	-1.1	0.7	1.8
Labour Productivity growth [2)]	-0.4	3.9	1.1	1.8	1.6	2.9	1.6	0.5	1.5	2.1	1.0
Tax rate on average wage earners [3)]	:	33.3	30.8	30.1	29.7	44.6	43.6	43.0	31.2	30.8	30.0
Tax rate on low wage earners[3)]	:	:	25.8	25.3	24.8	:	38.6	37.8	:	29.0	27.7
NRR on low income families (married) [4)]	:	67.0	49.0	:	:	72.0	67.0	:	59.0	59.0	:
NRR on low wage earners (single) [4)]	:	75.0	66.0	:	:	71.0	68.0	:	59.0	59.0	:

* The youth UR figure shown for 2001 for the UK is the average of the seasonally adjusted monthly rates for Jan-Oct 2001.
Note: For other footnotes and sources see Table 1.3 for Belgium.

15.4.2 Product markets and the knowledge-based economy

- **Overall assessment**

15. The United Kingdom is open (as measured by the total trade-to-GDP ratio) to international competition. The price level is above the EU average (partly due to the exchange rate) and the relatively low level of productivity remains a problem, even if it has been catching up with the EU average in recent years. The economic environment is favourable to entrepreneurship with low levels of regulation and relatively low corporate tax rates. State aid is among the lowest in the EU and liberalisation of the network industries is well advanced. However the UK's transposition deficit rose slightly to 2.8% in October 2001 and there are problems of under-investment in the transport sector.

16. The UK's IT expenditure (as a % of GDP) in 1999 and level of internet access in June 2001 were above the EU average. However the UK stills lags behind the US on both

these measures and the take-up of broadband internet in the UK is relatively low. Both the UK's total and business R&D expenditure (as a % of GDP) were around the EU average in 2000 and the Government has continued to take measures to promote R&D. The proportion of young people (aged 25-34) with at least upper secondary education, at 66% in 1999, was just below the EU average.

17. Some progress was made in implementing the 2001 product market recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendations in the 2001 BEPGs	*Degree of implementation*
➢ Take measures to address the relatively low level of productivity, in particular by increasing competition in sectors such as retail banking services, car retailing and postal services and by increasing the supply of skilled ICT personnel.	In progress
➢ Ensure that the announced investment to improve the transport infrastructure and to improve the quality of public transport is delivered in practice and ensure that there is adequate co-ordination between different public bodies, regulators and private firms.	Partial

18. The UK Government has taken several measures over the last year to increase productivity. As regards retail banking, the UK Government is considering a report from the Competition Commission into SME banking services which it received in October 2001 and is also committed to give new powers to the Office of Fair Trading to promote effective competition in payment systems. As regards car retailing, the UK Government issued an Order under the Fair Trading Act tackling some discriminatory practices whilst awaiting the review of the EC block exemption on vehicle distribution. As regards postal services, the Postal Services Commission (PSC) published a consultation document in January 2002 setting out draft proposals for a more competitive regime for postal services. To date the PSC has issued a licence to Consignia and temporary licences to five other operators for specific postal services. As regards ICT skills, considerable resources have been allocated to ICT in schools (£710 million committed between 2002 and 2004 in England). It is now compulsory for pupils to be taught ICT from age 5 to 16 either as a separate subject or by pupils' use of ICT through other subjects. The Government's strategy for skills also aims at training 10,000 more people per year in ICT skills through new advanced learning programmes. The Government is establishing 6000 UK Online centres by the end of 2002, which will offer internet, access in the community and enable more people to gain good basic ICT skills.

19. The UK Government started its 10-Year Plan for Transport in April 2001. The Plan foresees a 75 per cent increase in capital investment (in real terms) compared to the previous 10 years in England (with the exception of spending on railways, which covers the whole of the UK). In particular this involves a 14 per cent per year increase (in real terms) in transport expenditure between 2000/01 and 2003/04. As regards roads, the backlog of road maintenance has been cleared and there is a commitment to 50 major national road schemes in the Targeted Programme of Investment (TPI), of which 22 are expected to be underway by the end of the next financial year. As regards railways, punctuality and reliability have improved from the low levels following the Hatfield rail crash. However Railtrack, the UK's rail infrastructure company, is currently in

administration and the UK Government is preparing its proposals for a successor company. As regards co-ordination, the UK Government is reconsidering the form which independent regulation of the railways should take and is currently preparing proposals.

Table 15.4: **Product market indicators for United Kingdom**

	UK				EU 15			
	1998	1999	2000	2001	1998	1999	2000	2001
Labour productivity[1]	95.4	93.3	94.7	95.5	100	100	100	100
Relative price levels[2]	108.0	112.0	118.0		100	100	100	
Total trade to GDP ratio (%)[3]	21.1	20.7	22.1	21.4	21.7	21.8	24.8	24.7
FDI share[4]	4.9	5.3	7.2		2.7	5.0	8.9	
Cross-border M&A share[5]	29(16.7)	26(16.7)	26(18.2)		100	100	100	
Single Market Directives[6]	2.1	2.8	2.7	2.8	3.9	3.6	3.0	2.0
Value of tenders in the O.J.[7]	3.0	2.7	3.8		1.8	1.8	2.4	
Sectoral and ad hoc State aids[8]	0.5	0.4			1.0	0.9		
Prices in telecommunications[9]								
- Local	0.64	0.64	0.64	0.64	0.41	0.41	0.41	0.41
- National	1.29	1.29	1.29	1.29	2.16	1.69	1.34	1.15
- Call to USA	3.85	3.85	3.85	3.85	5.07	4.09	3.39	2.65
Market share fixed telecom (%)[10]								
- Local		73.4	68.0					
- Long Distance		65	59.0					
- International		49.4	48.0					
Electricity prices[11]								
- Households	10.17	10.05	10.21	10.48	10.57	10.48	10.40	10.33
- Industry users	5.77	5.92	7.01	6.37	6.44	6.32	6.44	6.33
Market share electricity (%)[12]		15						
Education expenditure[7]	4.6	4.6	4.9		5.0	5.0	5.1	
New S&T graduates[13]	15.2	15.6	16.2					
R&D expenditure[7]	1.83	1.87	1.84		1.87	1.92	1.90	
Internet access at home[14]		17.0	40.9	46.5		12.0	28.4	36.1
Patent applications[15]	101.0	111.2	124.0		129.9	140.9	152.7	

Note: For footnotes and source see Table 1.4 for Belgium.

15.4.3 Capital markets

- **Overall assessment**

20. The global integration of UK capital markets continued in 2001 with an increase of foreign clients in UK equity trading as well as in UK clients trading in foreign equities. Toward the end of 2001, the acquisition of LIFFE by Euronext was announced (and completed early in 2002). In the banking sector, consolidation continued in 2001 but was limited by competition concerns.

21. In terms of regulatory framework, the Financial Services Authority (FSA) is the single statutory regulator of financial services since end November 2001. The merging in a

single framework of the supervision of banks, insurance companies and securities firms will promote cross-sector regulation.

22. In terms of market efficiency, new regulations to improve settlement in CREST (introduction of electronic transfer of title of securities and delivery versus payment in central bank money on that date), the UK's securities settlement system, have been laid before Parliament. Further to the Cruickshank report on competition in UK banking, voluntary codes of banking and mortgage services were reviewed, leading to a number of recommendations directed at improving competition and increasing the levels of customer service in banking sectors. The Office of Fair Trading is to be given new powers to promote effective competition in payments systems for the benefit of consumers.

23. Regarding consumer protection, the Government is to liberalise the way some retail investments can be sold. Further to the decision to close Equitable Life Insurance Society to new business, an independent inquiry has been launched. The terms of reference to the enquiry are to examine the circumstances leading to the current situation and identify any lessons to be learned for the conduct, administration and regulation of life assurance. As foreseen last year, stakeholder pensions were launched with the aim of broadening private pension provision. Regarding savings, the budget 2001 confirmed the extension until 2006 of the contribution limit for Individual Savings Accounts. To support savings from low-income savers, two schemes are under discussion: the Saving Gateway and the Child Trust Fund. Competition in the savings market is presently under review. It might lead to some simplification of savings schemes in the future.

24. In terms of risk capital, the first half of 2001 saw a very steep fall in investments. To further improve the tax framework for enterprises, a number of measures are under consideration (i) an exemption for gains and losses on substantial shareholdings to ensure that important business decisions on corporate restructuring and reinvestment are made for commercial rather than tax reasons; (ii) a new regime for providing tax relief for the costs of intellectual property, goodwill and other intangible assets; (iii) modernising and simplifying the tax regime for corporate debt, financial instruments and foreign exchange gains and losses.

25. A reform of the bankruptcy and insolvency procedures is under discussion aimed at reducing the cost and stigma of failure, facilitating the rescue of viable business and providing certainty and fairness to creditors. To improve the supply of small scale and early stage risk capital across the country, a new business incubator fund was set up, a new Programme of Early Growth Funding is to be developed and Regional Venture Capital Funds are to be supported.

26. Some progress was made in implementing the 2001 capital market recommendations.

- **Implementation of the 2001 BEPGs**

Country-specific recommendation in the 2001 BEPGs	*Degree of implementation*
➢ Further encourage the role of pension funds in the development of the risk capital market.	In progress

27. In response to the recommendations made by the Myners Review on institutional investment decision-making, the UK government intends to consult on legal change to trustees' duties and a legal duty of shareholder activism. It has also already taken on board the recommendation by which an investment made in a limited partnership solely for the purpose of investing that money in private equity investments should be exempt from the prohibition in the Financial Services and Market Act on unauthorised persons engaging in investment activity.