edlemmerne af Folketingets Europaudvalg
g deres stedfortrædere

ilag	Journalnummer	Kontor	
	400.C.2-0	EUK	14. juni 2005

Til underretning for Folketingets Europaudvalg vedlægges i forbindelse med Det Europæiske Råds møde i Bruxelles den 16.-17. juni 2005 Rådets rapport vedrørende de overordnede økonomisk-politiske retningslinier, 9912/05.

COUNCIL OF
THE EUROPEAN UNION

Brussels, 8 June 2004

9912/05

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REPORT

from	:	the (ECOFIN) Council
to	:	the European Council
Subject:		Broad Economic Policy Guidelines - Report from the Council to the European Council

Delegations will find attached the report from the Council (ECOFIN) to the European Council on the Broad Economic Policy Guidelines (BEPGs), as adopted on 7 June.

The report comprises a cover note (Annex I) and a draft text for the BEPGs 2005-2008 (Annex II).

Cover note by the Council (ECOFIN) to the European Council on the 2005-2008 BEPGs (7 June 2005)

Increasing growth and employment in Europe

The European Council in March 2005 called for a relaunching of the Lisbon strategy without delay and a re-focusing of priorities on sustainable growth and employment. To achieve this goal, and in presenting these BEPGs to the European Council, the Council (ECOFIN) wishes to draw specific attention to two main priorities for policy action in the coming year, namely a) **increasing Europe's ability to create jobs**; and b) **raising productivity growth** through more effective competition and better conditions for investment, especially in knowledge and innovation, against a background of growth and stability orientated macroeconomic policies, and within a framework aimed at social cohesion and environmental sustainability.

Economic activity in the EU which had gathered momentum since mid-2003, decelerated in the second half of 2004, to a large extent because of the effect of external factors such as high and volatile oil prices and the appreciation of the euro. The sluggishness of the economic recovery of the EU, in the present cycle, is partly due to weak developments in domestic demand and low confidence amongst business and consumers, while underlying structural weaknesses persist.

1) Sound macroeconomic policies for growth and jobs

Sustainable and sound public finances, in full compliance with the Stability and Growth Pact, remain a necessary condition for sustainable growth and employment.

In light of Europe's ageing populations, many Member States need to pursue a satisfactory pace of government debt reduction to strengthen public finances and engage in significant pension and health care reforms in order to improve the long-term sustainability of public finances while ensuring adequate pensions and health care on a long term basis.

2) Improving Europe's ability to create jobs

Increasing employment in Europe has to be one of the top priorities for structural reform during the period 2005-2008. A key objective is to increase labour market participation and promote a lifecycle approach to work in order to increase hours worked in the economy. To this end, action is urgently needed to renew impetus in tax and benefit reform to improve incentives and to make work pay; increase adaptability of labour markets by combining job flexibility and employment security; and improve employability by investing in human capital. Furthermore, improving the regulatory environment, reducing the administrative burden on business, promoting entrepreneurship in general and improving framework conditions for SMEs will contribute to creating new firms and new jobs.

3) Fostering productivity growth

In order to improve the conditions for accelerated productivity growth, the priority areas for action are investment in education and R&D, in particular private R&D, and facilitating all forms of innovation and the spread of ICT, in order to boost innovation. The internal market should also be extended and deepened in order to make Europe a more attractive place to invest and work, while strengthening economic and social cohesion. Improving the business environment remains key to increasing productivity growth in the EU.

Better ownership is essential to improve **the implementation of the Lisbon strategy**. Later this year, the Member States will draw up, on their own responsibility, their National Reform Programmes, geared to their own specific situation and involving consultation with all relevant stakeholders. They should be based on the Integrated Guidelines, composed of the Broad Economic Policy Guidelines and the Employment Guidelines, and be consistent with the Stability and Convergence Programmes. These programmes, in combination with the Community Action Plan, will be instrumental to ensure the delivery of the renewed Lisbon strategy, and therefore need to be ambitious. The National Reform Programmes should as far as possible contain clear policy goals. The Ecofin Council will continue the existing multilateral surveillance of the implementation of the BEPGs, with a special focus on the priorities above.

Draft for

The Broad Guidelines for the Economic Policies of the Member States and the Community (2005-2008)

Introduction

The European Council of March 2005 **relaunched the Lisbon strategy by refocusing on growth and employment in Europe**[1]. By taking this decision, the Heads of State and Government have delivered a clear message concerning the Union's priorities over the next few years. Europe must focus its policies further on growth and employment to achieve the Lisbon goals, against a sound macro-economic policy background and within a framework aimed at social cohesion and environmental sustainability, which are vital pillars of the Lisbon strategy.

Particular attention needs to be paid to the delivery of the Lisbon agenda. In order to achieve these objectives, the Union must do more to mobilise all the resources at national and Community levels so that their synergies can be put to more effective use. Furthermore, the involvement of relevant stakeholders can help to raise awareness of the need for growth and stability orientated macro-economic policies and for structural reforms, improve the quality of implementation, and increase the sense of ownership of the Lisbon strategy.

To this end, these Broad economic policy guidelines (BEPGs) reflect the new start for the Lisbon strategy and concentrate on the contribution of economic policies to higher growth and more jobs. Section A of these BEPGs deals with the contribution that macroeconomic policies can make in this respect. Section B focuses on the measures and policies that the Member States should carry out in order to boost knowledge and innovation for growth and to make Europe a more attractive place to invest and work. In line with the conclusions of the Brussels European Council (22 and 23 March 2005), as a general instrument for coordinating economic policies, the BEPGs should continue to embrace the whole range of macroeconomic and microeconomic policies, as well as employment policy insofar as this interacts with those policies; the BEPGs will ensure general economic consistency between the three strands of the strategy. The existing multilateral surveillance arrangements for the BEPGs will continue to apply.

[1] Conclusions of the European Council of March 2005, (http://ue.eu.int/cms3_fo/showPage.asp?lang=en&id=432&mode=g&name).

These guidelines are applicable to all Member States and to the Community. They should foster coherence of reform measures included in the National Reform Programmes established by Member States and will be complemented by the Lisbon Community Programme 2005-2008 covering all action to be undertaken at Community level in the interest of growth and employment. Implementation of all relevant aspects of these guidelines should take into account gender mainstreaming.

The state of the EU economy

Economic activity in the EU which had gathered momentum since mid-2003, decelerated in the second half of 2004 because of the effect of external factors such as high and volatile oil prices, the slowdown in world trade expansion and the appreciation of the euro. In part, lack of resilience in some European economies may also originate from persisting structural weaknesses. Real GDP growth is expected to continue at a moderate pace in 2005, but the lower than expected carry over from 2004 will inevitably affect the overall annual average. The contribution of domestic demand to the recovery has so far been uneven among Member States, but a gradual strengthening is expected during the year, supported by favourable financing conditions (including low real interest rates) and contained inflationary pressures.

The economic recovery has to a large extent been dependent upon the resurgence of global growth and the rapid increase in world trade. As the world growth cycle reaches maturity and absorbs the dampening effect of higher world oil prices, the emphasis will fall increasingly on domestic demand in the EU to provide greater impetus to the upswing. Structural and macro-policies need to be thought of against the background of an increase in the prices of raw materials, notably oil, and a downward pressure on industrial prices. The return to potential growth rates in the EU therefore depends to a large extent on increasing confidence among businesses and consumers, as well as on favourable global economic developments, including oil prices and exchange rates. Against this background, it is important that economic policies inspire confidence and thereby help to create conditions for stronger domestic demand and job creation on the short term, and that structural reforms contribute to an expansion of growth potential in the medium term.

Unemployment rates are projected to decrease, albeit slowly, to 8.7% in 2006. The estimated overall employment rate is 63.0% for EU-25 in 2003, which is significantly below the agreed target level of 70%. Progress towards the female employment rate target of 60% has been slow, with the rate now standing at 55.1% for EU-25, but is expected to pick up again. The employment rate of older workers, which continued to climb to just over 40.2% has the largest gap to bridge towards the 50% target for 2010. At the same time, progress in improving quality in work has been mixed and the economic slow-down has raised the profile of social inclusion problems. Long-term unemployment increased again after several years of decline and seems unlikely to fall in the near future.

The sluggishness of the EU's economic recovery is a continuing source of concern. The EU economy is in several respects further away from its goal of becoming the world's most competitive economy than was the case in March 2000. Against this background, the gulf between Europe's growth potential and that of its economic partners has not significantly narrowed.

- The first explanation for the continued under-performance of the Union economy is that its **labour input remains comparatively low**. Efforts made by the Member States allowed the employment rate to increase from 61.9% in 1999 to 63.0% in 2003. However, there remains a considerable scope for further improvement, notably among young and older workers, if the Lisbon targets are to be reached.

- The second key explanation for the EU's poor performance is linked to its **low level of productivity growth**. Productivity growth has been on a declining trend for several decades.

Section A – Macroeconomic policies for growth and jobs[2]

A.1 Macroeconomic policies creating the conditions for more growth and jobs

Securing economic stability to raise employment and growth potential

Sound macroeconomic policies are essential to support a well-balanced economic expansion and the full realisation of current growth potential. They are also vital for establishing framework conditions that will promote adequate levels of savings and investment, as well as a stronger orientation of the latter towards knowledge and innovation, so as to position the economy on a sustained, higher, non-inflationary, growth and employment path. This should help to maintain favourable long term interest rates and to contribute to reasonable exchange rate developments. In planning for the future, firms and individuals must have confidence that price stability will be maintained.

Monetary policies can contribute by pursuing price stability and, without prejudice to this objective, by supporting other general economic policies with regard to growth and employment. For new Member States, it will be important that monetary policies contribute towards achieving sustainable real - and nominal - convergence. Exchange rate regimes constitute an important part of the overall economic and monetary policy framework and should be orientated towards achieving real and sustainable nominal convergence. Participation in ERM II, at an appropriate stage after accession, should help those endeavours. An additional macroeconomic policy challenge for some of these Member States is to keep current account deficits within the range where sound external financing can be secured. In this respect, fiscal restraint will be essential to reduce current account deficits.

[2] In implementing the policy guidelines set out below, Member States should note that the country-specific recommendations issued in the context of the Council Recommendation of 26 June 2003 on the broad guidelines of the economic policies of the Member States and the Community (for the 2003-2005) period as completed and updated in the context of the Council Recommendation of 5 July 2004 on the 2004 update of these guidelines, remain valid as background references.

Securing a sound budgetary position will allow the full and symmetric play of the automatic budgetary stabilisers over the cycle with a view to stabilising output around a higher and sustainable growth trend. For those Member States that have already achieved sound budgetary positions the challenge is to retain that position. For the remaining Member States, it is vital to take all the necessary corrective measures to achieve their medium term budgetary objectives in particular if economic conditions improve, thus avoiding pro-cyclical policies and putting themselves in a position in which sufficient room for the full play of automatic stabilisers over the cycle is ensured prior to the next economic downturn. In line with the Ecofin report "Improving the implementation of the Stability and Growth Pact" endorsed by the European Council (22-23 March 2005), for individual Member States the medium-term budgetary objective should be differentiated according to the diversity of economic and budgetary positions and developments as well as of fiscal risk to the sustainability of public finances, also in the face of prospective demographic changes. The Stability and Growth Pact requirements applying to the euro area Member States also apply to ERM II Member States.

Guideline n°1. To secure economic stability for sustainable growth, 1. in line with the Stability and Growth Pact, Member States should respect their medium-term budgetary objectives. As long as this objective has not yet been achieved, they should take all the necessary corrective measures to achieve it. Member States should avoid pro-cyclical fiscal policies. Furthermore, it is necessary that those Member States having an excessive deficit take effective action in order to ensure a prompt correction of excessive deficits. 2. Member States posting current account deficits that risk being unsustainable should work towards correcting them by implementing structural reforms, boosting external competitiveness and, where appropriate, contributing to their correction via fiscal policies. *See also integrated guideline "To contribute to a dynamic and well-functioning EMU" (n°6)*

Safeguard long-term economic sustainability in the light of Europe's ageing population

Europe's ageing population poses serious risks to the long-term sustainability of the European Union economy. According to the latest projections, by 2050 the EU's population of working age (15-64) will be 18% lower than in 2000 and the number of people aged over 65 years will have increased by 60%. This not only implies higher dependency ratios, it also means that, unless action is taken now to safeguard long-term fiscal sustainability, there could be an increased debt burden, due to the increase in the age-related public expenditure, and lower potential output per capita, due to the reduction in the working age population, and future difficulties financing the pension, social insurance and health care systems.

Member States should address the economic implications of ageing by, as part of the well-established three pronged strategy for tackling the budgetary implications of ageing, pursuing a satisfactory pace of debt reduction and providing incentives to raise employment rates and increase labour supply so as to offset the impact of future declines in the number of persons of working age. Notwithstanding the recent increase, to 63.0% in 2003, the still relatively low employment rate indicates that Europe has a reservoir of unused labour. The scope for further improvements is thus considerable, notably amongst women, young and older workers. In line with this strategy, it is also essential to modernise social protection systems so as to ensure that they are financially viable, providing incentives to the working age population to actively participate in the labour market, while at the same time ensuring that they fulfil their goals in terms of access and adequacy. In particular, improved interaction between social protection systems and labour markets can remove distortions and encourage the extension of working lives against a background of increased life expectancy.

Guideline n°2. To safeguard economic and fiscal sustainability as a basis for increased employment, Member States should, in view of the projected costs of ageing populations, 1. undertake a satisfactory pace of government debt reduction to strengthen public finances, 2. reform and re-enforce pension, social insurance and health care systems to ensure that they are financially viable, socially adequate and accessible, and 3. take measures to increase labour market participation and labour supply especially amongst women, young and older workers, and promote a lifecycle approach to work in order to increase hours worked in the economy. *See also integrated guideline "Promote a lifecycle approach to work" (No 17, and 4, 18, 20).*

Promote a growth, employment orientated and efficient allocation of resources

Well-designed tax and expenditure systems that promote an efficient allocation of resources are a necessity for the public sector to make a full contribution towards growth and employment, without jeopardising the goals of economic stability and sustainability. This can be achieved by redirecting expenditure towards growth-enhancing categories such as Research and Development (R&D), physical infrastructure, environmentally friendly technologies, human capital and knowledge. Member States can also help to control other expenditure categories through the use of expenditure rules and performance budgeting and by putting assessment mechanisms in place to ensure that individual reform measures and overall reform packages are well-designed. A key priority for the EU economy is to ensure that tax structures and their interaction with benefit systems promote higher growth potential through more employment and investment.

Guideline n°3. To promote a growth, employment orientated and efficient allocation of resources Member States should, without prejudice to guidelines on economic stability and sustainability, redirect the composition of public expenditure towards growth-enhancing categories in line with the Lisbon strategy, adapt tax structures to strengthen growth potential, ensure that mechanisms are in place to assess the relationship between public spending and the achievement of policy objectives and ensure the overall coherence of reform packages. *See also integrated guideline "To encourage the sustainable use of resources and strengthen the synergies between environmental protection and growth (n° 11)".*

Ensure that wage developments contribute to growth and stability and complement structural reforms

Wage developments can contribute to stable macroeconomic conditions and an employment-friendly policy mix provided that real wage increases are in line with the underlying rate of productivity growth over the medium term and are consistent with a rate of profitability that allows for productivity, capacity and employment-enhancing investment. This requires that temporary factors such as variation in productivity caused by cyclical factors or one off rises in the headline rate of inflation do not cause an unsustainable trend in wage growth and that wage developments reflect local labour market conditions.

Given the continued upward pressure on oil and raw material prices, vigilance is needed over the impact of wage settlements and labour cost increases on price stability and price competitiveness. The fact that this second round effect has not been observed so far is welcome. These issues need to be taken into account in the continued dialogue and information exchange between monetary and fiscal authorities and the social partners via the Macroeconomic Dialogue.

Guideline n°4. To ensure that wage developments contribute to macroeconomic stability and growth and to increase adaptability Member States should encourage the right framework conditions for wage-bargaining systems, while fully respecting the role of the social partners, with a view to promote nominal wage and labour cost developments consistent with price stability and the trend in productivity over the medium term, taking into account differences across skills and local labour market conditions. *See also integrated guideline "Ensure employment-friendly wage and other labour cost developments" (No 21)*

Promote coherent macroeconomic, structural and employment policies

The role of sound macroeconomic policies is to provide conditions conducive to employment creation and growth. Structural reforms, consistent with sound fiscal positions in the short and medium term, are essential to increase productivity and employment in the medium-term, thus leading to the full realisation and strengthening of growth potential. They also contribute to fiscal sustainability, macroeconomic stability and resilience to shocks. At the same time, appropriate macro-economic policies are key towards reaping the full benefits of structural reforms in term of growth and employment. A key feature of Member States' overall economic strategy is to ensure that they have a consistent set of structural policies that support the macroeconomic framework and vice versa. In particular, market reforms need to improve the overall adaptability and adjustment capacity of economies in response to changes in cyclical economic conditions and also longer term trends such as globalisation and technology. In this regard, an effort towards reforms of tax and benefit systems should be pursued in order to make work pay and avoid any possible disincentive for labour market participation.

Guideline n°5. To promote greater coherence between macroeconomic, structural and employment policies, Member States should pursue labour and product markets reforms that at the same time increases the growth potential and support the macroeconomic framework by increasing flexibility, factor mobility and adjustment capacity in labour and product markets in response to globalisation, technological advances, demand shift, and cyclical changes. In particular, Member States should renew impetus in tax and benefit reforms to improve incentives and to make work pay; increase adaptability of labour markets combining employment flexibility and security; and improve employability by investing in human capital. *See also integrated guideline "Promote flexibility combined with employment security and reduce labour market segmentation" (No 20 and No 18).*

A.2 ENSURING A DYNAMIC AND WELL-FUNCTIONING EURO AREA

The need to achieve higher growth and employment is particularly acute in the euro area given its recent subdued economic performance and its low level of potential growth of around 2% (Commission estimates). In its last spring forecast, the Commission revised downwards its prevision for 2005 at a 1.6% growth in the eurozone. Economic divergence may increase in the euro zone, in terms of growth, internal demand and inflation pressures. The deceleration of economic growth in the euro area in the second half of last year can be attributed to both external factors - high and volatile oil prices, slowing global trade growth and the appreciation of the euro - as well as internal rigidities. On the external side, adverse oil price developments and persisting global imbalances continue to represent non-negligible downside risks.

Domestic demand has been particularly muted in the euro area, with both private consumption and investment significantly below that of the EU-25 as a whole in 2004. Muted private consumption seems to be rooted in continuing concerns regarding in particular employment prospects (with unemployment continuing to be around 9%) as well as income prospects in the medium term. The level of confidence and the lack of sustained improvement on the consumption side have continued to weight on investment.

The challenge for the euro area is to ensure the realisation of current growth potential and even more to raise its growth potential over time. This is best achieved through growth and stability orientated macroeconomic policies and comprehensive structural reforms. Both are also particularly salient for euro area and ERMII Member States as they have an important impact on their capacity to adequately adjust to shocks with an asymmetric impact and therefore on the economic resilience of the euro area as a whole. Furthermore, the economic performance of, and policies pursued by, individual euro area Member States affect common goods such as the euro's exchange rate, interest rates price stability and the cohesion of the euro area. All this implies a need for effective policy coordination, both in the EU and in the euro area, to improve growth potential and performance.

The absence of national interest and exchange rate policies implies also an increased need to achieve and maintain sound budget positions over the cycle which provide sufficient budgetary margin to absorb the impact of cyclical fluctuations or economic shocks with an asymmetric impact. Structural policies that foster the smooth adjustment of prices and wages are essential to ensure that euro area Member States have the capacity to rapidly adjust to shocks (such as the current oil price shock) and to help to avoid unwarranted inflationary developments. Policies that increase the responsiveness of labour markets, through encouraging widespread labour participation, occupational and geographical mobility and the setting of wages, together with appropriate product market reforms, are particularly important in this respect.

In the short run, the policy mix in the euro area needs to support economic recovery while at the same time safeguarding long-term sustainability and stability. At the current juncture, it is important that the policy mix underpins confidence among consumers and investors which also implies remaining committed to medium-term stability. Budgetary policy has to ensure a fiscal position consistent with the need to prepare for the impact of ageing populations on the one hand and to accomplish a composition of public expenditure and revenues that fosters economic growth on the others.

To contribute to international economic stability and better represent its economic interests, it is critical for the euro area to play its full role in international monetary and economic policy cooperation. Whilst a stable Eurogroup Presidency will help to coordinate euro area members' positions, the external representation of the euro area has to be improved, on the basis of the framework of the Vienna agreement of 11 and 12 December 1998, so that the euro area can take a leading strategic role in the development of the global economic system.

Guideline n°6 To contribute to a dynamic and well-functioning EMU, euro area Member States need to ensure better co-ordination of their economic and budgetary policies, in particular 1. pay particular attention to fiscal sustainability of their public finances in full compliance with the Stability and Growth Pact; 2. contribute to a policy mix that supports economic recovery and is compatible with price stability, and thereby enhances confidence among business and consumers in the short run, while being compatible with long term sustainable growth; 3. press forward with structural reforms that will increase euro area long-term potential growth and will improve its productivity, competitiveness and economic adjustment to asymmetric shocks, paying particular attention to employment policies; and 4. ensure that the euro area's influence in the global economic system is commensurate with its economic weight.

Section B – Microeconomic reforms to raise Europe's growth potential

Structural reforms are essential to increase the EU's growth potential and support macroeconomic stability, because they increase the efficiency and adaptability of the European economy. Productivity gains are fuelled by competition, investment and innovation. Raising Europe's growth potential requires making progress in both job creation and productivity growth. Since the mid-1990s, productivity growth in the EU has slowed down markedly. Part of this slowdown comes from increased employment of low-skilled workers. However, reversing this trend in productivity is a major challenge facing the Union, especially in the light of its ageing population. Population ageing alone is estimated to reduce by nearly half the current rate of potential growth. An acceleration of productivity growth and increasing hours worked are thus indispensable to maintain and increase future living standards, and ensure a high level of social protection.

B.1 Knowledge and innovation– engines of sustainable growth

Knowledge accumulated through investment in R&D, innovation and education is a key driver of long-run growth. Policies aimed at increasing investment in knowledge and strengthening the innovation capacity of the EU economy are at the heart of the Lisbon strategy for growth and employment. This is why national and regional programmes will be increasingly targeted on investments in these fields in accordance with the Lisbon objectives.

Increase and improve investment in R&D, with a view to establishing the European Knowledge Area

R&D affects economic growth through various channels: first, it can contribute to the creation of new markets or production processes; second, it can lead to incremental improvements in already existing products and production processes; and third, it increases the capacity of a country to absorb new technologies.

The EU is currently spending around 2% of GDP on R&D (although ranging from below 0.5% to above 4% of GDP across Member States), barely up from the level at the time of the launch of the Lisbon strategy. Moreover, only around 55% of research spending in the EU is financed by the business sector. Low levels of private R&D investments are identified as one of the main explanation for the EU/US innovation gap. More rapid progress towards meeting the collective EU target of raising research investment to 3% of GDP is needed. Member States are invited to report on their R&D expenditure targets for 2008 and 2010 and the measures to achieve these in their national Lisbon programmes. The main challenge is to put in place framework conditions, instruments and incentives for companies to invest in research.

Public research expenditure must be made more effective and the links between public research and the private sector have to be improved. Poles and networks of excellence should be strengthened, better overall use should be made of public support mechanisms to boost private sector innovation, and a better leverage effect of public investments and a modernised management of research institutions and universities should be ensured. It is also essential to ensure that companies operate in a competitive environment since competition provides an important incentive to private spending on innovation. In addition, a determined effort must be made to increase the number and quality of researchers active in Europe, in particular by attracting more students into scientific, technical and engineering disciplines, and enhancing the career development and the transnational and intersectoral mobility of researchers, and reducing barriers to mobility of researchers and students.

The international dimension of R&D should be strengthened in terms of joint financing, development of a more critical mass at the EU level in critical areas requiring large funds and through reducing barriers to mobility of researchers and students.

Guideline n°7. To increase and improve investment in R&D, in particular by private business, the overall objective for 2010 of 3% of GDP is confirmed with an adequate split between private and public investment, Member States will define specific intermediate levels. Member States should further develop a mix of measures appropriate to foster R&D, in particular business R&D, through: 1. improved framework conditions and ensuring that companies operate in a sufficiently competitive and attractive environment; 2. more effective and efficient public expenditure on R&D and developing PPPs; 3. developing and strengthening centres of excellence of educational and research institutions in Member States, as well as creating new ones where appropriate, and improving the cooperation and transfer of technologies between public research institute and private enterprises; 4. developing and making better use of incentives to leverage private R&D; 5. modernising the management of research institutions and universities; 6. ensuring a sufficient supply of qualified researchers by attracting more students into scientific, technical and engineering disciplines and enhancing the career development and the European, international as well as inter-sectoral mobility of researchers and development personnel.

Facilitate innovation

The dynamism of the European economy is crucially dependent on its innovative capacity. The economic framework conditions for innovation need to be in place. This implies well functioning financial and product markets as well as efficient and affordable means to enforce intellectual property rights. Innovations are often introduced to the market by new enterprises, which may meet particular difficulties in obtaining finance. Measures to encourage the creation and growth of innovative enterprises, including improving access to finance, should therefore enhance innovative activity. Technology diffusion, and policies to better integrate national innovation and education systems, can be fostered by the development of innovation poles and networks as well as by innovation support services targeted at SMEs. Knowledge transfer via researcher mobility, Foreign Direct Investment (FDI) or imported technology is particularly beneficial for lagging countries and regions.

Guideline n°8. To facilitate all forms of innovation, Member States should focus on: 1. improvements in innovation support services, in particular for dissemination and technology transfer; 2. the creation and development of innovation poles, networks and incubators bringing together universities, research institution and enterprises, including at regional and local level, helping to bridge the technology gap between regions; 3. the encouragement of cross-border knowledge transfer, including from foreign direct investment; 4. encouraging public procurement of innovative products and services; 5. better access to domestic and international finance, and 6. efficient and affordable means to enforce intellectual property rights.

The diffusion of information and Communication Technologies (ICT), in line with the objectives and actions of the upcoming i2010 initiative, is also an important way to improve productivity and, consequently, economic growth. The EU has been unable to reap the full benefits of the increased production and use of Information and Communication Technologies (ICT). This reflects the still continuing under-investment in ICT, institutional constraints and organisational challenges to the adoption of ICT. Technological innovation ultimately depends on a growth-conducive economic environment. In this context the use of intelligent logistics is an efficient way of ensuring that costs at the European sites of production remain competitive. A market of electronic communication open and competitive is also important in this regard.

Guideline n°9. To facilitate the spread and effective use of ICT and build a fully inclusive information society, Member States should: 1. encourage the widespread use of ICT in public services, SMEs and households; 2. fix the necessary framework for the related changes in the organisation of work in the economy; 3. promote a strong European industrial presence in the key segments of ICT; 4. encourage the development of strong ICT and content industries, and well functioning markets; 5. ensure the security of networks and information, as well as convergence and interoperability in order to establish an information area without frontiers; 6. encourage the deployment of broad band networks, including for the poorly served regions, in order to develop the knowledge economy. *See also integrated guide-*

line "To promote flexibility combined with employment security and reduce labour market segmentation" (n°21)

To strengthen the competitive advantages of the European industrial base

The recent slowdown in EU productivity growth is partly related to the EU's difficulty in re-orienting its economy towards the higher productivity growth sectors.

In order to enhance and sustain economic and technological leadership Europe must increase its capacity to develop and market new technologies, including ICT. The synergies from jointly addressing research, regulatory and financing challenges at the European level, where for reasons of scale or scope individual Member States cannot successfully tackle market failures in isolation, should be analysed and exploited. The EU has still not managed to fully realise its technological potential. The pooling of European excellence and the development of public-private partnerships and cooperation between Member states where the benefits for society are larger than those for the private sector will help tap this potential.

Guideline n°10. To strengthen the competitive advantages of its industrial base, Europe needs a solid industrial fabric throughout its territory. The necessary pursuit of a modern and active industrial policy means strengthening the competitive advantages of the industrial base, including by contributing to attractive framework conditions for both manufacturing and services, while ensuring the complementarity of the action at national, transnational and European level. Member States should: 1. start by identifying the added value and competitiveness factors in key industrial sectors, and addressing the challenges of globalisation. 2. also focus on the development of new technologies and markets. a) This implies in particular commitment to promote new technological initiatives based on public-private partnerships and cooperation between Member States, that help tackle genuine market failures. b) This also implies the creation and development of networks of regional or local clusters across the EU with greater involvement of SMEs. *See also integrated guideline "Improve matching of labour market needs" (n°20)*

Encourage the sustainable use of resources

Lasting success for the Union also depends on addressing a range of resource and environmental challenges which, if left unchecked will act as a brake on future growth. In this context, recent developments and prospects on oil prices have emphasised the acuity of the energy efficiency issue. A policy towards energy efficiency is important to reduce the vulnerability of the European economy to oil prices variations. Further delay in addressing these challenges would raise the economic costs of taking action. This implies for example measures to make more rational use of resources. Measures in this area will also be important to tackle the problem of climate change. In this context, it is important that Member States renew efforts to meet the obligations according to the Kyoto protocol. Member States should notably continue the fight against climate change in order to achieve that the global temperature increase does not exceed 2°C above pre-industrial levels, while implementing the Kyoto targets in a cost-effective way. Member States should pursue the engagement of halting the loss of biological diversity between now and 2010, in particular by incorporating this requirement into other policies, given the importance of biodiversity for certain economic sectors. The use of market-based instruments, so that prices better reflect environmental damage and social costs, plays a key role in this context. Encouraging the development and use of environment-friendly technologies, the greening of public procurement, paying particular attention to SMEs, and the removal of environmentally harmful subsidies alongside other policy instruments can improve the innovative performance and enhance the contribution to sustainable development of the sectors concerned. For example, EU companies are amongst the world leaders in developing new renewable energy technologies. In particular, in a context of continued upward pressure on energy prices, and accumulating threats to the climate, it is important to push energy efficiency improvements as a contribution to both growth and sustainable development.

Guideline n°11. To encourage the sustainable use of resources and strengthen the synergies between environmental protection and growth, Member States should: 1. give priority to energy efficiency and co-generation, the development of sustainable, including renewable, energies and the rapid spread of environmentally friendly and eco-efficient technologies a) inside the internal market on the one hand particularly in transport and energy, inter alia in order to reduce the vulnerability of the European economy to oil price variations, b) towards the rest of the world on the other hand as a sector with a considerable export potential; 2. promote the development of means of internalisation of external environmental costs and decoupling of economic growth from environmental degradations. The implementation of these priorities should be in line with existing Community legislation and with the actions and instruments proposed in the Environmental Technologies Action Plan (ETAP), *inter alia,* through a) the use of market-based instruments, b) risk funds and R&D funding, c) the promotion of sustainable production and consumption patterns including the greening of public procurement, d) paying a particular attention to SMEs and e) a reform of subsidies that have considerable negative effects on the environment and are incompatible with sustainable development, with a view to eliminating them gradually. 3. pursue the objective of halting the loss of biological diversity between now and 2010, in particular by incorporating this requirement into other policies, given the importance of biodiversity for certain economic sectors. 4. continue to fight against climate change, while implementing the Kyoto targets in a cost-effective way, particularly in regard to SMEs. *See also integrated guideline "To promote an efficient allocation of resources" (n°3)*

B.2 MAKING EUROPE A MORE ATTRACTIVE PLACE TO INVEST AND WORK

The attractiveness of the European Union as an investment location depends *inter alia* on the size and openness of its markets, its regulatory environment, the quality of its labour force and its infrastructure.

Extend and deepen the Internal Market

Whilst the Internal Market for goods is relatively well integrated, services markets remain, legally or *de facto*, rather fragmented and labor mobility remain low in Europe. In order to promote growth and employment and to strengthen competitiveness, the internal market of services has to be fully operational while preserving the European social model. The European Council has requested all efforts to be undertaken within the legislative process in order to secure a broad consensus for moving towards a single market for services. The elimination of obstacles to cross-border activities would also bring important efficiency gains. Finally, the full integration of financial markets would raise output and employment by allowing more efficient allocation of capital and creating better conditions for business finance.

Despite general acknowledgement of the potential benefits of a single European market, the transposition rate of Internal Market directives remains disappointingly low. Furthermore, directives are often not implemented or applied correctly, as illustrated by the high number of infringement proceedings launched by the Commission. Member States need to cooperate more positively with each other and with the Commission to ensure that they deliver the full benefits of Internal Market legislation to their citizens and businesses. For example, there is considerable scope for further improvements in public procurement practices. Such improvements would be reflected in an increase in the share of public procurement publicly advertised. Moreover, more open procurement would lead to significant budgetary savings for the Member States.

Guideline n°12. To extend and deepen the Internal Market, Member States should: 1. speed up the transposition of Internal Market directives; 2. give priority to stricter and better enforcement of Internal Market legislation; 3. eliminate remaining obstacles to cross-border activity; 4. apply EU public procurement rules effectively; 5. promote a fully operational internal market of services, while preserving the European social model; 6. accelerate financial market integration by a consistent and coherent implementation and enforcement of the Financial Services

Action Plan. See also integrated guideline "To improve matching of labour market needs" (n°20)

Ensure open and competitive markets inside and outside Europe

The open global economy offers new opportunities for stimulating growth and competitiveness in Europe´s economy. Competition policy has played a key role in ensuring a level playing field for firms in the EU, and can also be instrumental to look at the wider regulatory framework around markets, in order to promote the conditions which will allow firms to compete effectively. A further opening up of European markets to competition can be achieved by a reduction in the general level of remaining State aid. This movement must be accompanied by a redeployment of remaining State aid in favour of support for certain horizontal objectives. The review of state aid rules should lead to a further push in this direction.

Structural reforms that ease market entry are a particularly effective tool for enhancing competition. These will be particularly important in markets that were previously sheltered from competition because of anticompetitive behaviour, the existence of monopolies, over-regulation (for example permits, licences, minimum capital requirements, legal barriers, shop opening hours, regulated prices, etc. may hinder the development of an effective competitive environment), or because of trade protection.

In addition, the implementation of measures already agreed to open up the network industries to competition (in the areas of electricity and gas, transport, telecommunications and postal services) should help to ensure lower prices overall and greater choice while guaranteeing the delivery of services of general economic interest to all citizens. Competition and regulatory authorities should ensure competition in liberalised markets. At the same time, the satisfactory delivery of high quality Services of general economic interest at an affordable price must be guaranteed.

External openness to trade and investment, also in a multilateral context, by increasing both exports and imports, is an important spur to growth and employment and can thus reinforce the delivery of structural reform. An open and strong system of global trade rules is of vital importance for the European economy. The successful completion of an ambitious and balanced agreement in the framework of the Doha-Round as well as the development of bilateral and regional free trade agreements, should further open up markets to trade and investment, thus contributing to raising potential growth.

Guideline n°13. To ensure open and competitive markets inside and outside Europe, reap the benefits of globalisation, Member States should give priority to: 1. the removal of regulatory, trade and other barriers that unduly hinder competition; 2. a more effective enforcement of competition policy; 3. selective screening of markets and regulations by competition and regulatory authorities in order to identify and remove obstacles to competition and market entry; 4. a reduction in State aid that distorts competition; 5. in line with the upcoming Community Framework, a redeployment of aid in favour of support for certain horizontal objectives such as research, innovation and the optimisation of human capital and for well-identified market failures; 6. the promotion of external openness, also in a multilateral context; 7. full implementation of the agreed measures to open up the network industries to competition in order to ensure effective competition in European wide integrated markets. At the same time, the delivery, at affordable prices, of effective services of general economic interest has an important role to play in a competitive and dynamic economy.

Improve European and national regulation

Market regulation is essential to create an environment in which commercial transactions can take place at competitive price. It also serves to correct market failures or to protect market participants. Nevertheless, the cumulative impact of regulations may impose substantial economic costs. It is therefore essential that regulations are well-designed and proportionate. The quality of the European and national regulatory environments is a matter of joint commitment and shared responsibility at both the EU and member state level.

When preparing or revising legislation, Member States should systematically assess the costs and benefits of their legislative initiatives. They should improve the quality of their regulations, while preserving their objectives. This implies consultation of relevant stakeholders. In the Commission's approach to better regulation, the economic, social and environmental impacts of new or revised regulations are carefully assessed to identify the potential trade-offs and synergies between different policy objectives. Moreover, existing regulation is screened for simplification potential and its impact on competitiveness is assessed. Finally, a common approach to measuring the administrative costs of new and existing legislation is being developed. Member States should establish systems for simplification of existing regulation. They should consult widely on the costs and benefits of their regulatory initiatives or their lack of action, particularly where trade-offs between different policy objectives are implied. Member States should also ensure that appropriate alternatives to regulation are given full consideration.

Significant improvements in the regulatory environment can therefore be achieved by taking into account cost-benefit considerations associated with regulation, including administrative costs. This is especially important for small and medium-sized enterprises (SMEs), which usually have only limited resources to deal with the administration imposed by both Community and national legislation.

Guideline n°14. To create a more competitive business environment and encourage private initiative through better regulation, Member States should: 1. reduce the administrative burden that bears upon enterprises, particularly on SMEs and start-ups; 2. improve the quality of existing and new regulations, while preserving their objectives, through a systematic and rigorous assessment of their economic, social (including health) and environmental impacts, while considering and making progress in measurement of the administrative burden associated with regulation, as well as the impact on competitiveness, including in relation to enforcement; 3. encourage enterprises in developing their corporate social responsibility.

Europe needs to foster its entrepreneurial drive more effectively and it needs more new firms willing to embark on creative or innovative ventures. Learning about entrepreneurship through all forms of education and training should be supported and relevant skills provided. The entrepreneurship dimension should be integrated in the life long learning process as from school. To this end, partnerships with companies should be encouraged. The creation and growth of businesses can also be encouraged by improving access to finance and strengthening economic incentives, including by adopting tax systems to reward success, reducing non-wage labour costs and reducing the administrative burdens for start-up notably through the provision of relevant business support services, notably for young entrepreneurs, like the creation of one-stop contact points and the stimulation of national support networks for enterprises. Particular emphasis should be put on facilitating the transfer of ownership and improving rescue and restructuring proceedings in particular with more efficient bankruptcy laws.

Guideline n°15. To promote a more entrepreneurial culture and create a supportive environment for SMEs, Member States should: 1. improve access to finance, in order to favour their creation and growth, in particular micro-loans and other forms of risk capital; 2. strengthen economic incentives, including by simplifying tax systems and reducing non-wage labour costs; 3. strengthen the innovative potential of SMEs, and 4. provide relevant support services, like the creation of one-stop contact points and the stimulation of national support networks for enterprises, in order to favour their creation and growth in line with Small firms' Charter. In addition, Member States should reinforce entrepreneurship education and training for SMEs. They should also facilitate the transfer of ownership, modernise where necessary their bankruptcy laws, and improve their rescue and restructuring proceedings. *See also integrated guidelines "To promote a growth, employment orientated and efficient allocation of resources" (n°3) and "To facilitate all forms of innovation" (n°8), n° 22 and 23.*

Expand and improve European infrastructure

Modern infrastructure is an important factor affecting the attractiveness of locations. It facilitates the mobility of persons, goods and services throughout the Union. Modern transport, energy and electronic communication infrastructure is an important factor of a re-invigorated Lisbon strategy. By reducing transport costs and by widening markets, interconnected and interoperable trans-European networks help foster international trade and fuel Internal Market dynamics. Moreover, the ongoing liberalisation of European network industries fosters competition and drives efficiency gains in these sectors.

In terms of future investment in European infrastructure, the implementation of 30 priority transport projects identified by Parliament and Council in the Trans European Network (TEN) transport guidelines as well as the implementation of the Quick-start cross-border projects for transport, renewable energy and broadband communications and research identified under the European Initiative for Growth and the implementation of the transport projects supported by the Cohesion Fund should be considered a priority. Infrastructure bottlenecks within countries need to be tackled as well. Appropriate infrastructure pricing systems can contribute to the efficient use of infrastructure and the development of a sustainable modal balance.

Guideline n°16. To expand, improve and link up European infrastructure and complete priority cross-border projects with the particular aim of achieving a greater integration of national markets within the enlarged EU. Member States should: 1. develop adequate conditions for resource- efficient transport, energy and ICT infrastructures – in priority, those included in the TEN networks - by complementing Community mechanisms, notably including in cross-border sections and peripherical regions, as an essential condition to achieve a successful opening up of the network industries to competition; 2. consider the development of public-private partnerships; 3. consider the case for appropriate infrastructure pricing systems to ensure the efficient use of infrastructures and the development of a sustainable modal balance, emphasizing technology shift and innovation and taking due account of environmental costs and the impact on growth. *See also integrated guideline "To facilitate the spread of ICT and build a fully inclusive information society"(n°9)*