COMMISSION OF THE EUROPEAN COMMUNITIES

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COMMISSION RECOMMENDATION

on the 2004 update of the Broad Guidelines of the Economic Policies of the Member States and the Community (for the 2003-2005 period)

(presented in accordance with Article 99(2) of the EC Treaty)

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I. GENERAL ECONOMIC POLICY GUIDELINES

1. The existing strategy remains valid

The Council adopted a recommendation on 26 June 2003 on the broad guidelines of the economic policies of the Member States and the Community for the 2003-2005 period[1]. These Broad Economic Policy Guidelines (BEPGs) constitute the EU's medium-term economic policy strategy. The BEPGs focus on the contribution that *economic* policies can make to the fulfilment of the strategic Lisbon goal. They are concentrated around:

- growth- and stability-oriented macroeconomic policies;
- economic reforms to raise Europe's growth potential; and
- strengthening sustainability.

Against the background of the results of a first assessment of the follow-up given to the 2003-05 BEPGs as presented in the Implementation Report[2] and the guidance from the Spring 2004 European Council, this recommendation updates and completes the existing strategy. No major policy adjustments are deemed necessary that would warrant a change in the general guidelines. The focus in this update is on the integration of the ten new Member States into the existing economic policy coordination framework.

Part I of this update concentrates on relevant considerations in applying the general guidelines in the 2003-2005 BEPGs to the new Member States. The existing general guidelines all remain valid and are unchanged. They are applicable to all Member States and to the Community. With a view of completing the existing strategy, Part II presents country-specific recommendations for the ten new Member States. It also contains updates of the country-notes for Germany, Greece, France, Italy, the Netherlands, Portugal and the United Kingdom to allow for policy adjustments in the area of budgetary policies.

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[1] Council recommendation of 26 June 2003 on the broad guidelines of economic policies of the Member States and the Community (for the 2003-05 period), 2003/555/EC, published in the Official Journal No. L 195/1 of 1 August 2003.

[2] Commission Communication 'First Report on the Implementation of the 2003-2005 Broad Economic Policy Guidelines' COM(2004)20 final, adopted on 21 January 2004.

2. IMPROVED ECONOMIC BACKGROUND

The economic recovery is finally taking hold in the EU supported by a general improvement in the international environment. GDP growth has gradually strengthened since the adoption of the BEPGs in the summer of 2003, with exports having been the main driver in the beginning of the recovery, despite a strengthening of the euro. Conditions are also in place for an improvement in domestic demand: confidence among businesses and consumers has picked up, interest rates are at historically low levels, and equity prices have been recovering. Against this background, the Spring Economic Forecast 2004 foresees a further recovery and growth is expected to reach potential towards the end of 2004. It is necessary to consolidate these first signs of growth. The European Council endorsed in December 2003 the initiative to launch targeted action in order to facilitate sustainable growth.

Inflation is expected to fall below 2 per cent during 2004 and to further ease in 2005. While increases in administered prices and indirect taxes will have an upward impact on prices in 2004, the unwinding of the temporary effects from past increases in some food prices have an opposite effect. Similarly, the appreciation of the euro will hold back price increases. For example, this has largely absorbed the rise in the dollar price of oil. Furthermore, wage moderation is expected to continue in the medium-term and with the cyclical recovery in labour productivity, growth in nominal unit labour costs can fall back markedly thereby contributing to price stability.

The labour market situation tends to reflect economic developments with a lag. Following a stand-still in 2003, employment is expected to benefit from the turnaround and pickup of overall economic activity, which took place in the second half of last year. However, given the gradual nature of the recovery, employment is expected to increase modestly this year and to rise more strongly next year.

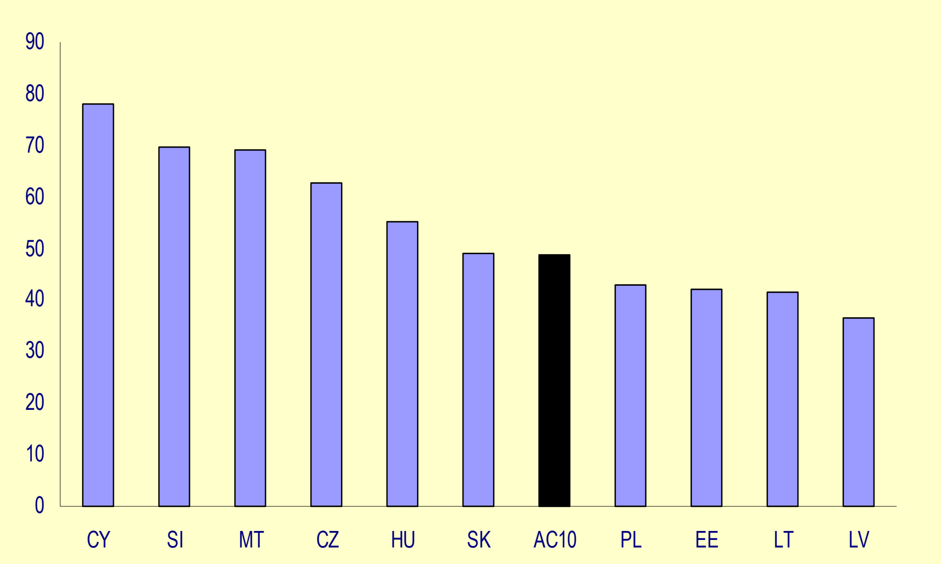
Overall, economic developments are in line with the prevailing expectations when adopting the medium-term economic policy strategy: the economy is recovering, albeit at a moderate pace, and the outlook for 2004-05 does not point to any macroeconomic imbalances requiring a policy change. At the same time, the forecast illustrates the still slow adjustment capacity of the EU economy and the low level of potential growth. It is therefore essential that the improving economic conditions should be fully seized upon to make decisive progress in closing the "delivery gap" in terms of discrepancy between envisaged and eventually adopted structural reform measures. The current pick-up in economic activity could be further underpinned by sound macroeconomic policies and by determined implementation of all the growth-enhancing economic reforms outlined in the 2003-05 BEPGs.

3. INTEGRATING THE TEN NEW MEMBER STATES INTO THE 2003-05 BEPGS

The accession of Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia on 1 May 2004 will be a major event in the Union's history.

Enlargement will contribute to new economic dynamism with mutually reinforcing effects. The new Member States' growth potential is estimated at around 4 per cent per year, reflecting *inter alia* their solid progress in recent years with structural and institutional reforms. The Internal Market will be expanded to 455 million citizens. Notwithstanding recent progress, it must be recognised that their starting position is different and that the acceding countries will initially only account for 5 per cent of the Union's GDP. With income levels of less than half of those of the EU-15 on average (see Graph 1), the main challenges for the acceding countries are to secure real convergence in the long-run, whilst at the same time achieving nominal convergence in the short to medium-term.

Graph 1: **GDP per capita 2003 (EU-15=100)**



Source: Commission services (Eurostat, Structural indicators).

The structural challenges faced by the new Member States do not differ fundamentally from those of the present ones, even if some challenges are more demanding.[3] The existing economic policy strategy would thus appear to be

[3] European Economy, occasional paper no. 4 'Key structural challenges in the acceding countries: the integration of acceding countries into the Community's economic policy co-ordination processes' by Economic Policy Committee, July 2003.

broadly appropriate. The scale of the challenges faced by these countries makes it crucial to find an appropriate balance between different policy requirements. For instance, in view of the still incomplete structural shift to a modern service-oriented market economy, most acceding countries need to pursue policies favouring real convergence. The EU will contribute importantly to real convergence by investment in the regions lagging behind through the cohesion- and structural funds as well as the European Investment Bank. However, national budgets must also cater for the important financing requirements linked to the need to upgrade the physical and human capital base, and fiscal authorities will have to cope with expenditure pressures stemming from the completion of transition reforms, while ensuring fiscal rectitude. At the same time and in view of an initial average budget deficit of some 6 per cent of GDP, it will be essential to ensure the necessary consolidation of public finances to underpin macroeconomic stability.

The subsequent sections review the existing economic policy strategy and highlight those general guidelines or policy areas, where the specific circumstances of most acceding countries are such that a longer adjustment period could be warranted. It must be stressed that differences are sizeable across the acceding countries. Taking due account of differences in their economic performances, prospects, structures and institutions, Part II of this update presents country-specific recommendations to the individual acceding countries.

3.1 Growth and stability-oriented macroeconomic policies

Sound macroeconomic policies play a crucial role in sustaining growth and employment and in preserving price stability. The new Member States should, just as the existing ones, aim at achieving well-balanced growth that fully realises the growth potential. In addition, as regards most acceding countries, macroeconomic policies must also be able to support the remaining structural shift towards a more services oriented economy.

The new Member States will need to seek a strong synergy between the necessary structural reforms and macroeconomic policies that underpin stability. Exchange rate regimes constitute an important part of the overall economic- and monetary policy framework and should be oriented towards achieving real- and sustainable nominal convergence. Participation in ERM II, at some stage after accession, should help those endeavours. A credible monetary policy will allow for a further decline in long-term interest rates that is conducive to both the much needed high level of investment and fiscal consolidation.

As regards the need to ‘reach or maintain sound budgetary positions’, an appropriate time path must be found between the speed of the necessary budget consolidation and an appropriate fiscal stance supporting the transition. Budgetary surveillance as regards the new Member States will start with the examination of their Convergence Programmes. Particular attention will be paid to country-specific circumstances, in particular to: initial budgetary positions, ongoing structural shifts in the economies and the possible risks resulting from current account imbalances and strong credit growth. It could be appropriate, from an economic point of view, to allow for a multi-annual adjustment period in some cases when correcting a deficit of more than 3 per cent. This would allow the new Member States to consolidate their public finances in a sustainable way, while at the same time completing the restructuring of the economy. In general, efficiency of public spending can be considerably enhanced, *inter alia* through a redirection of public spending towards growth-enhancing, cost-effective investments in physical and human capital and in research and innovation. In addition, a broadening of tax bases on labour and improving tax collection so as to ensure the appropriate revenues could facilitate a reduction of labour tax rates (including high social security contribution rates).

Table 1: Macroeconomic indicators for the new and the current Member States in 2003

	AC10	EU15
GDP growth (real, % p.a.)	3.6	0.8
Inflation (% p.a.)	2.1	2.0
Current account (% of GDP)	-3.7	0.2
Unemployment (%)	14.3	8.0
Government balance (% of GDP)	-5.7	-2.6

AC10= the ten acceding countries.

Source: Commission services (incl. Eurostat, structural indicators).

The current account deficit amounted to some 3¾ per cent of GDP on average in 2003 in the new Member States, reflecting the catching-up process and sizeable domestic savings-investment gaps. A major macroeconomic policy challenge for some of the acceding countries therefore consists of keeping relatively high current account deficits within the range where sound external financing can be secured. In this respect, fiscal restraint and the need to avoid pro-cyclical policies will be essential to reduce current account deficits, as its financing could become more difficult once the privatisation process is fully completed.

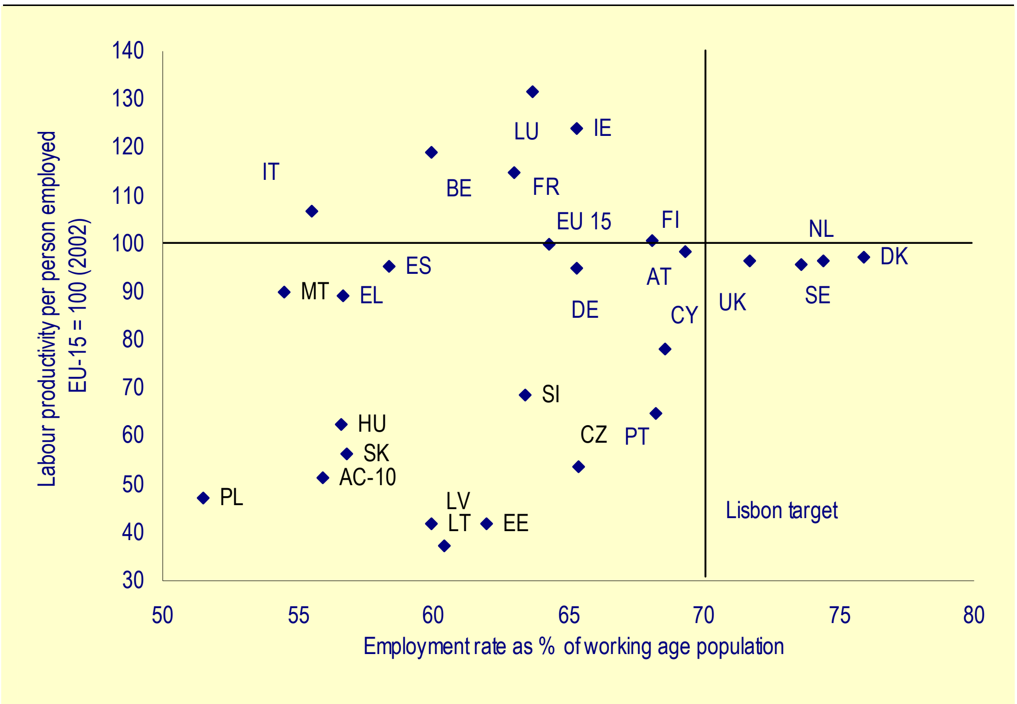
A stable macroeconomic environment requires nominal wage increases that are consistent with both price stability and productivity gains. It will also be important for wage formation in the acceding countries to support the restructuring of the economy by allowing wages to better reflect differences in local labour market conditions across firms, sectors, regions and occupations. Beyond this, real wage developments need to support external competitiveness in the new Member States in light of the need to attract foreign direct investment.

3.2 Economic reforms to raise Europe's growth potential

Catching-up in income levels is a long-term process. It will be crucial to narrow both the gap in employment rates and productivity levels between the acceding countries and the EU-15. The existing guidelines aiming at '*more and better jobs*' and at '*increasing productivity and business dynamism*' are best implemented in a comprehensive and coordinated way.

The contribution that employment policies can make is reflected in the existing guidelines that concentrate on 'making work pay' and on pricing people back into jobs, particularly the low-skilled or those living in poorer regions. The labour market situation is considerably worse in the acceding countries, with employment rates either static or on a downward path, high unemployment rates (they also tend to be of a long-term nature and concentrated amongst young people), large numbers of inactive persons and sizeable informal sectors. It will therefore be essential that policy efforts concentrate on a small number of priority areas that are likely to have the largest impact on labour market performances: ensuring that real wage developments reflect productivity growth; improving the financial incentives to work by reforming tax/benefit systems; improving human capital formation, *inter alia* through the provisions of lifelong learning facilities; and undertaking appropriate reforms of labour market regulations. Employment policies need to support the ongoing process of large structural shifts in the sectoral and regional composition of employment.

Graph 2: **Employment and productivity levels in the EU Member States and acceding countries (2002)**



Source: Commission services (Eurostat, structural indicators).

It will be essential to raise both employment rates and to improve productivity growth simultaneously for the new Member States (see Graph 2). The ongoing restructuring of their economies is instrumental in improving the generally low productivity level. The transition from a specialisation in low-value added and/or low labour cost activities towards higher value-added activities should take account of current comparative advantages. Increased economic integration into the Internal Market and accompanying measures to promote competition in the economy should speed up the restructuring process in the new Member States. Increased competition requires more rapid progress with privatisation, cutbacks in the use of administered prices, a reduction in the regulatory burden on business and greater support for entrepreneurship. In this context, the capacity of central and local authorities to enforce legislation needs to be strengthened, in particular as regards the legal rules on market entry and exit of companies.

Table 2: Economic indicators for the new and the current Member States in 2003

	AC10	EU15
GDP per capita [1]	48.7	100
Productivity per person employed [2]	53.6	100
Employment rate (in 2002) [3]	55.9	64.3
Business investments (% of GDP)[4]	17.9	17.2
Total FDI inflows (% of GDP) [5]	5.0	4.4
R&D expenditure (% of GDP)[6]	0.83	1.98

[1] in PPS, level, EU15=100. [2] GDP in PPS per person employed, level, EU15=100. [3] Total employment rate - Employed persons aged 15-64 as a share of the total population of the same age group, 2002. [4] Gross fixed capital investments by the private sector, 2002. [5] 2002. [6] Gross domestic expenditure on R&D, 2001.

Source: Commission services (incl. Eurostat, structural indicators).

Productivity growth will be further enhanced by the transition of new Member States to a knowledge-based economy, which is at the centre of the EU Lisbon strategy. Also, the European Initiative for Growth underlines the importance of investments in networks and in research as crucial steps to boost growth, better integrate an enlarged Europe and improve productivity and competitiveness. For the new Member States, R&D diffusion and technology transfers are as important as R&D investment as a tool for accelerating the transition towards higher value-added activities. Sustaining a high level of foreign direct investment is essential in this endeavour, as is an increased responsiveness of the education and training systems to the changing needs of the labour market[4]. Reforms of the education and training systems would also help to encourage the move to more innovative, knowledge-intensive activities, as would investments in environmental technologies.

An important role in allocating and channelling savings towards productive investments and establishing investor confidence is played by smoothly functioning, developed capital markets. While the capital markets have grown in

[4] Joint interim report of the Council and the Commission 'Education and Training 2010', adopted on 26 February 2004.

the acceding countries since the early 1990s (both in terms of size and value), they generally remain underdeveloped relative to most of the current Member States (except for Cyprus and Malta). Rapid integration into the single market for financial services by a quick transposition and implementation of all the *acquis* in this area, will be all the more important to support the development of a sound and well-capitalised financial sector and for maintaining a level playing field for financial institutions in an enlarged EU. In addition, the capital markets in most of the new Member States are characterised by a high level of bank intermediation (typically making up more than 80 per cent of total financial assets in Central Europe and the Baltic States) and extensive foreign bank ownership (except for Cyprus and Slovenia), while several are also experiencing a rapid development of other financial intermediaries such as pension funds (e.g. Poland). In this context, it will be particularly important for the new Member States to further strengthen their financial supervisory arrangements and improve cross-border cooperation in financial supervision and financial crisis management.

3.3 Strengthening sustainability

The BEPGs put considerable emphasis on ensuring that growth is sustainable in the EU, by integrating economic, social, and environmental sustainability into the economic policy strategy.

An ageing population will imply similar challenges for economic sustainability in the new Member States as in the EU-15. While their starting positions are better in general (with lower debt levels in most cases), the demographic outlook is likely to have greater economic (and social) implications.

Table 3: Sustainability indicators for the new and the current Member States

	AC10	EU15
Government debt (2003, % of GDP)	42.2	64.0
Employment rate of older workers[1]	30.4	40.1
Long-term unemployment rate[1]	8.1	3.0
Greenhouse gas emissions[2]	69	98
Energy intensity[3]	709	194

[1] Figures for 2002. [2]Figures for 2001, 1990 base year =100. [3] Energy consumption in 2001 divided by GDP at constant prices, kilogram of oil equivalent per 1000 Euro.

Source: Commission services (incl. Eurostat, structural indicators).

Overall, sound economic policies make an important contribution to social sustainability as jobs play a vital role in lifting people out of poverty and social exclusion. In the new Member States, additional emphasis must be put on modernising social protection systems and improving the skills of the work force, with a view to increasing participation rates and improving mobility. The low employment rates of both young and older workers require special attention in this respect. Pronounced regional disparities need to be addressed, notably by ensuring efficient investments and an appropriate wage differentiation (reflecting differences in productivity). In addition, the business environment has to be improved, particularly by capacity building measures in public administration. This should also enhance the efficiency in the use of EU Structural and Cohesion funds.

The substantial investments in energy and transport infrastructure that are needed in most of the new Member States aim at reducing the environmental impacts of energy and transport use and improving energy efficiency. Such investments will be crucial as their energy intensities exceed those of current Member States by a factor of almost 4, see Table 3, in spite of improvements of as much as 6% per year over the last decade. In particular, it will be essential to take full account of the costs of environmental damage in investment decisions, including by reducing energy subsidies and introducing appropriate taxes and charges, for example for energy consumption and/or transport use.

II. COUNTRY-SPECIFIC ECONOMIC POLICY GUIDELINES

Part II contains updates of the country-notes for Germany, Greece, France, Italy, the Netherlands, Portugal and the United Kingdom. It also presents country-notes for the ten new Member States.

The Council adopted the broad guidelines of the economic policies for the 2003-05 period for the current Member States on 26 June 2003. The country-specific recommendations therein generally remain valid, although some of them need to be updated to allow for necessary policy adjustments in the area of budgetary policies.

It is important to note that, even when measures have been taken that partly or even fully address a particular recommendation, that recommendation is not updated until a full assessment of their impact can be carried out. The pace and nature of progress in the implementation of the various guidelines is reviewed in the annual Implementation Report.

1. Belgium

No update.

2. Denmark

No update.

3. Germany

One of the challenges facing Germany is to "reduce rapidly the general government deficit to below 3 per cent of GDP and keep government finances on a steady consolidation path". In order to achieve this, Germany was recommended in the 2003 version of the Broad Economic Policy Guidelines to:

- ensure a rigorous budget execution and implement the announced or compensatory measures for 2003 amounting to 1 per cent of GDP and put an end to the present excessive deficit situation by 2004 at the latest (recommendation 6); and

- lower the cyclically-adjusted deficit by at least one percentage point of GDP between the end of 2003 and 2005 (recommendation 7).

These two recommendations were similar to those addressed by the Council to Germany on 21 January 2003 in accordance with Articles 104(7) of the Treaty. On 18 November 2003, the Commission adopted two recommendations on the basis of Article 104(8) and 104(9) respectively for the Council to decide (1) that action taken by Germany was inadequate to bring the excessive deficit to an end and (2) to give notice to Germany to take the necessary measures to bring the general government deficit below 3 per cent of GDP in 2005 at the latest. On 25 November 2003, the Council did not adopt the two Commission recommendations but adopted instead a set of conclusions endorsing, *inter alia*, the commitments made by Germany to reduce the cyclically-adjusted deficit by 0.6 per cent of GDP in 2004, and by 0.5 per cent of GDP or a larger amount in 2005 so as to ensure that the general government deficit would be brought below 3 per cent of GDP in 2005. In its Opinion on the 2003 update of the stability programme of Germany[5], the Council reaffirmed these conclusions.

In the light of these developments and bearing in mind that budgetary plans for the years beyond 2005 are to an important extent formed within the period covered by the BEPGs (*inter alia* in the multi-annual stability programmes), recommendations 6 and 7 are replaced by the following:

“6. achieve an annual reduction in the cyclically-adjusted deficit of 0.6 per cent of GDP in 2004 and of at least 0.5 per cent of GDP or a larger amount in 2005 so as to ensure that the general government deficit is brought below 3 per cent of GDP in 2005 (GL 1);

7. should the recovery in economic activity be stronger than currently expected, allocate any higher-than-expected revenues to deficit reduction and accelerate the reduction in the cyclically-adjusted deficit;

7bis ensure that the budgetary consolidation continues in the years after 2005, namely through a steady reduction in the cyclically-adjusted budgetary deficit by at least 0.5 percentage points of GDP per year or more if necessary to achieve the medium term position of government finances close to balance or in surplus and bring back the debt ratio to a declining path (GL 1).”

4. Greece

One of the challenges facing Greece is to “ensure the long-term sustainability of public finances in the face of population ageing, in particular in view of the high government debt ratio”. In order to achieve this, Greece was *inter alia* recommended in the 2003 version of the Broad Economic Policy Guidelines to:

- ensure effective control of government current primary spending by addressing resolutely the problem of the inelastic elements of expenditures, e.g. the wage bill (recommendation 2).

According to the fiscal data for 2003, as communicated by the Greek authorities but not yet validated by Eurostat, the general government deficit would have stayed only just below the 3 per cent of GDP reference value. This represents a considerable widening of the deficit compared to 2002 in spite of a positive output

[5] OJ C68, 18.3.2004.

gap, reflecting the pro-cyclical, expansionary nature of Greek fiscal policies. For 2004, there is a distinct risk that the reference value for the deficit may be breached. Greece is moving further away from a budgetary position of close to balance or in surplus.

In the light of these developments, recommendation 2 is replaced by the following:

“2. take appropriate measures to avoid the occurrence of an excessive deficit; move towards achieving a medium-term close to balance or in surplus position by ensuring an improvement in the cyclically-adjusted budget balance of at least 0.5 per cent of GDP per year, specifically through effective control of government current primary spending (GL 1).”

5. Spain

No update.

6. France

One of the challenges facing France is to “reduce rapidly the general government deficit to below 3 per cent of GDP and keep government finances on a steady consolidation path”. In order to achieve this, France was recommended in the 2003 version of the Broad Economic Policy Guidelines to:

- achieve a significantly larger improvement in the cyclically-adjusted deficit in 2003 than that currently planned (recommendation 1);

- implement measures ensuring that the cyclically-adjusted deficit is reduced in 2004 by 0.5 per cent of GDP, or by a larger amount, so as to ensure that the cumulative improvement in 2003-2004 is enough to bring the nominal deficit below 3 per cent in 2004 at the latest (recommendation 2); and

- limit the increase in the general government gross debt to GDP ratio in 2003 (recommendation 3).

These three recommendations were similar to those addressed by the Council to France on 3 June 2003 in accordance with Article 104(7) of the Treaty. On 8 and 21 October 2003 respectively, the Commission adopted two recommendations on the basis of Article 104(8) and 104(9) respectively for the Council to decide (1) that no effective action had been taken by France in response to the recommendation of 3 June and (2) to give notice to France to take the necessary measures to bring the government deficit below 3 per cent of GDP in 2005 at the latest. On 25 November 2003, the Council did not adopt the two Commission recommendations but adopted instead a set of conclusions endorsing, *inter alia*, the commitments made by France to reduce the cyclically-adjusted deficit by 0.8 per cent of GDP in 2004, and by 0.6 per cent of GDP or a larger amount in 2005 so as to ensure that the general government deficit would be brought below 3 per cent of

GDP in 2005. In its Opinion on the 2003 update of the stability programme of France[6], the Council reaffirmed and further clarified these conclusions.

In the light of these developments and bearing in mind that budgetary plans for the years beyond 2005 are to an important extent formed within the period covered by the BEPGs (*inter alia* in the multi-annual stability programmes), recommendations 1, 2 and 3 are replaced by the following:

"1. achieve an annual reduction in the cyclically-adjusted deficit of 0.8 per cent of GDP in 2004 and of at least 0.6 per cent of GDP or a larger amount in 2005 so as to ensure that the general government deficit is brought below 3 per cent of GDP in 2005 (GL 1);

2. should the recovery in economic activity be stronger than currently expected, allocate any higher-than-expected revenues to deficit reduction and accelerate the reduction in the cyclically-adjusted deficit through the implementation of additional measures. In addition, any budgetary margin stemming from a slower than planned increase in expenditures should be allocated to deficit reduction;

3. ensure that the budgetary consolidation continues in the years after 2005, namely through a steady reduction in the cyclically-adjusted budgetary deficit by at least 0.5 percentage points of GDP per year or more if necessary to achieve the medium term position of government finances close to balance or in surplus and bring back the debt ratio to a declining path (GL 1)."

7. Ireland

No update.

8. Italy

One of the challenges facing Italy is to "rapidly consolidate public finances". In order to achieve this, Italy was inter alia recommended in the 2003 version of the Broad Economic Policy Guidelines to:

- Until a medium-term budget position of close to balance or in surplus is achieved, ensure a reduction in the cyclically-adjusted deficit of at least 0.5 per cent of GDP per year, replacing one-off measures by measures of a more permanent character (recommendation 1).

The fiscal data for 2003 show that the general government deficit was 2.4 per cent of GDP, almost unchanged compared to 2002 (2.3 per cent). In a context of weak economic growth, the authorities have continued to rely on temporary measures to

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[6] OJ C43, 19.2.2004.

restrain the deficit. Such measures are estimated to have improved the budgetary outturn by slightly more than 2 percentage points of GDP (around 1.5 percentage points in 2002). Markedly lower interest expenditure compared to the previous year also helped stave off a larger increase in the deficit. In 2004, with reliance of one-off measures to be reduced by half, there is a distinct risk that the 3 per cent of GDP reference value for the deficit may be exceeded. With the output gap practically unchanged, the development in the cyclically-adjusted balance is also unfavourable. The adjustment towards a position close to balance in cyclically-adjusted terms is further set back.

In light of these developments, recommendation 1 is replaced by the following:

“1. take appropriate measures to avoid the occurrence of an excessive deficit; move towards achieving a medium-term close to balance or in surplus position by ensuring an improvement in the cyclically-adjusted budget balance of at least 0.5 per cent of GDP per year, replacing one-off measures by measures of a more permanent character (GL 1).”

9. Luxembourg

No update.

10. The Netherlands

One of the challenges facing the Netherlands is to “pursue budgetary adjustment in the coming years in the face of weaker potential growth, and the budgetary costs of ageing”. In order to achieve this, the Netherlands was recommended in the 2003 version of the Broad Economic Policy Guidelines to:

- continue to contain government expenditure within clearly defined ceilings set in real terms, consistent with a budgetary position close to balance or in surplus (recommendation 1).

The fiscal data for 2003 show that the general government deficit increased to 3.2 per cent of GDP. This deterioration is linked to the sharp economic downturn, which led to a stronger-than-expected increase in the deficit, despite a substantial package of fiscal savings. For 2004, there is a risk that the 3 per cent of GDP reference value for the deficit might be exceeded as well. However, taking into account the widening of the output gap, the development of the cyclically-adjusted balance is more favourable. In cyclically-adjusted terms an adjustment towards a position close to balance is underway.

In the light of these developments, recommendation 1 is replaced by the following:

“1. stand ready to take the necessary measures in response to the possible existence of an excessive deficit, while continuing to contain government expenditure within clearly defined ceilings set in real terms, consistent with a medium-term budgetary position close to balance or in surplus (GL 1 and 14).”

11. Austria

No update.

12. Portugal

One of the challenges facing Portugal is to "accelerate the consolidation of public finances and address the strong dynamics of government expenditure". In order to achieve this, Portugal was inter alia recommended in the 2003 version of the Broad Economic Policy Guidelines to:

- ensure that the government deficit is further reduced in 2003 as planned and that the cyclically-adjusted deficit is thereafter lowered by at least 0.5 per cent of GDP a year in order to reach a budget position that is close to balance (recommendation 1).

The fiscal data for 2003 show a general government deficit of 2.8 per cent of GDP, thereby in compliance with the Council Recommendation of 5 November 2002 addressed to Portugal under Article 104(7) of the Treaty, which called for a government deficit below the 3 per cent of GDP reference value by 2003 at the latest. The large negative output gap associated with the economic recession of 2003 hindered considerably the process of budgetary consolidation, because of the massive shortfall in tax revenue that developed during 2003 (excluding the one-off measure on the sale of tax and social contributions arrears). Although the government has been broadly successful in securing the planned restraint of expenditure (i.e. growth in current primary expenditure continued to decelerate from 8.9 per cent in 2001 to 7.8 per cent in 2002 and 4.1 per cent in 2003), the shortfall in tax revenue induced by the recession led the government to rely, to a significant degree, on one-off measures for a second consecutive year (1.5 and 2.1 per cent of GDP in 2002 and 2003 respectively). For 2004, there is a distinct risk that the reference value for the deficit may again be exceeded in view of slow growth and the only partial replacement planned so far of the significant amount of one-off measures adopted in 2003.

In light of these developments, recommendation 1 is replaced by the following:

"1. take appropriate measures to avoid that the deficit breaches the 3 per cent of GDP reference value again; move towards achieving a medium-term close to balance or in surplus position by ensuring an improvement in the cyclically-adjusted budget balance of at least 0.5 per cent of GDP per year, replacing one-off measures by measures of a more permanent character (GL 1)."

13. Finland

No update.

14. Sweden

No update.

15. United Kingdom

The fiscal data for 2003 show that the general government deficit was 3.2 per cent of GDP, above the 3 per cent of GDP reference value. The budgetary position deteriorated more than planned in 2003 due principally to weaker-than-expected direct tax receipts. In the medium term, both the headline and cyclically-adjusted deficits are projected to decline to just below 2 per cent of GDP, in the context of continuing increases in planned expenditure aimed at addressing past under-investment by the public sector and under-provision of public services. The projected deficit path does not, however, allow a sufficient safety margin to prevent a breach of the 3 per cent of GDP reference value with normal macroeconomic fluctuations. Furthermore, there are risks to the budgetary projections stemming from the assumed autonomous rise in the revenue ratio.

In the light of these developments, the United Kingdom faces an additional challenge compared to the 2003 version of the Broad Economic Policy Guidelines, namely to:

Strengthen the budgetary position so as to avoid emerging budgetary imbalances

In order to strengthen the budgetary position so as to avoid emerging budgetary imbalances, the United Kingdom is recommended to:

"6. stand ready to take the necessary measures so as to endeavour to avoid the occurrence of an excessive deficit; improve the cyclically-adjusted position to consolidate the public finances, consistent with a budgetary position of close to balance or in surplus in the medium term (GL 1)."

16. Cyprus

The small economy, with tourism as a mainstay, has shown some resilience in the face of a difficult international environment. At first, steady and high real GDP growth averaging 4.2 per cent for 1997-2001 was driven both by domestic demand and continued high growth in tourist arrivals. However, after 11 September 2001 the economy was hit by the slump in tourism linked to international terrorist threats, war in Afghanistan and Iraq, and SARS, with the decline continuing in 2003. Growth therefore more than halved but still reached 2 per cent in 2002 and 2003, supported by moderate domestic demand. This is however below potential growth.

The relatively good growth performance was supported by a market economy dominated by the private sector and with, *inter alia*, a highly developed financial and legal system, generally prudent economic policies, and a flexible labour market. The latter has been operating close to full employment and with high participation rates; with unemployment rates fluctuating between 3-5 per cent, Cyprus effectively does not have an unemployment problem. At the same time, the crisis in (mass-) tourism in Cyprus has underlined the increasing economic dependence on this sector, while traditional sources of export earnings, particularly within the manufacturing sector, show a structural decline. Therefore, Cyprus may have an interest in increasing its diversification towards higher value added activities. To this end, Cyprus may accelerate the transition toward a knowledge-based economy and continue to simplify the business environment.

A fiscal consolidation plan was introduced in 1999 and revised and extended in following years. However, fiscal performance in 2002 and 2003 slipped again and consolidation was effectively abandoned as deficits increased to 4.6 per cent and 6.3 per cent of GDP respectively. The expansionary fiscal stance contributed to an increase in domestic demand and a current account deficit projected at 4.4 per cent of GDP for 2003. The government intends to tackle anew the fiscal deficit for this and following years, thus working towards a more favourable policy mix and supporting a narrowing of the current account deficit.

Policies in Cyprus should aim at achieving a high degree of sustainable convergence, in particular as regards the consolidation of public finances. Both the further consolidation of public finances and management of the increasing tourism dependence need to be supported by policies which assist in perpetuating the strong growth performance into the medium and long term. This requires in particular a strengthening of the growth and employment base and Cyprus should continue its further transition to a knowledge-based economy. It must be noted that the challenges outlined below are subject to unusual uncertainty as, in the event of reunification, the island's economic situation would fundamentally change. Against this background, Cyprus faces two major challenges:

- Ensure a reduction of the general government deficit on a sustainable basis,

- Increase the diversification of the economy towards higher value added activities.

Ensure a reduction of the general government deficit on a sustainable basis

Fiscal consolidation went increasingly off target in 2002 and 2003. The original fiscal consolidation plan, introduced in 1999, was revised in 2001 and again in 2002. It aimed at reducing the deficit to 2.0 per cent of GDP by 2002 while reaching fiscal balance by 2005. However, lower growth in 2002 brought the budget shortfall to 4.6 per cent of GDP, instead of a previously planned 2.6 per cent. For 2003 further slippage occurred, linked to continued modest growth and tax avoidance with marked revenue shortfalls, while spending increased through higher defence outlays and expansionary measures introduced to offset subdued external demand. This effectively rendered the consolidation program defunct, and the government deficit for 2003 reached 6.3 per cent of GDP. The expansionary fiscal stance contributed to an increase of domestic demand and to a continued relatively high current account deficit projected at 4.4 per cent of GDP for 2003. The government intends to tackle anew the fiscal deficit, thus working towards a more favourable policy mix and supporting a narrowing of the current account deficit. To put fiscal consolidation on track again significant corrective measures are required. The quality of public finances should improve due to a comprehensive fiscal reform, to be finished by end-2004. These reforms will support further deficit reductions and assist in keeping the current account deficit in sustainable territory if private net saving should become less favourable again.

Increase the diversification of the economy towards higher value added activities

While tourism accounts for around 15-20 per cent of GDP and employment, the economy has shown some resilience in the face of a difficult international environment. However, in a longer term perspective, Cyprus may have an interest to up-grade tourism activities and to develop other value added activities. In this respect, the Cypriot government has initiated a number of reforms to facilitate the transition towards a knowledge based economy. Nevertheless the low level of R&D expenditure, particularly by the business sector, and the lack of IT related skills may still be handicaps. Finally, both e-commerce and the percentage of households with internet access are quite limited.

A better business environment is also key to improving the efficiency of product markets. First, the Cypriot economy is dominated by small family enterprises whose expansion may be partly hindered by access to finance. Second, competition in the network industries is still limited. For example, the unbundling of the transmission system operator is still lacking in the electricity market. In November 2003, the regulator for the telecommunications and postal services sectors issued two decrees advancing but not completing the unbundling of the local loop in these sectors. Finally, barriers to market access remain in air transport and the *acquis* in the maritime sector still has to be fully implemented.

Country specific recommendations to Cyprus

Meeting the challenges outlined above requires broad structural reforms as they are laid down in the general guidelines (GL) in Part I of the Broad Economic Policy Guidelines.

In order to ensure a reduction of the general government deficit on a sustainable basis, Cyprus is recommended to:

1. reduce the general government deficit in a credible and sustainable way within a multi-annual framework in line with the decisions to be taken by the Council in the context of the forthcoming budgetary surveillance exercise (GL 1).

In order to increase the diversification of the economy towards higher value added activities, Cyprus is recommended to:

2. step up efforts to increase the adequacy of skilled human capital, promote R&D and innovation, in particular in the business sector, and improve conditions to facilitate ICT diffusion (GL 9, 13).

3. continue to simplify the business and taxation environment (GL 11).

17. Czech Republic

After the economic slowdown of 1997-1998, the Czech Republic's annual real GDP growth averaged about 3 per cent, with the exception of 2002 when the country was hit by serious floods and GDP growth reached only 2 per cent. The HICP inflation reached very low levels (1.4 per cent in 2002 and -0.1 per cent in 2003) and the monetary authorities were undershooting the inflation target. The growth performance has been underpinned by restructuring efforts, but output has not yet fully reached its estimated potential. The main restructuring process took place in the banking sector. The restructuring of the banking sector was accompanied by substantial fiscal costs as the state took over bad assets in the banks' balance sheets. Moreover, fiscal policy has been until recently somewhat relaxed, causing the general government deficit to surge. The expansionary fiscal stance contributed to a domestic demand boom and an increasingly consumption-driven widening of the current account deficit to more than 6 per cent of GDP.

Policies in the Czech Republic should aim at achieving a high degree of sustainable convergence, in particular as regards the consolidation of public finances. The economy has been characterised by relatively low growth in comparison with the other new Member States. Therefore, the further consolidation of public finances needs to be supported by policies which assist in accelerating the growth performance into the medium and long term. This requires, in particular, an effort to tackle the remaining structural shortcomings, notably in the labour market and in the business environment, and to speed up the transition towards a knowledge-based economy. Against this background, the Czech Republic faces four major challenges:

- Urgently ensure a further reduction of the general government deficit on a sustainable basis and the long-term sustainability of public finances,
- Continue to address the structural problems in the labour market,
- Improve conditions for an accelerated productivity growth,
- Promote entrepreneurship and SMEs.

Urgently ensure a further reduction of the general government deficit on a sustainable basis and the long-term sustainability of public finances

The general government deficit increased from 6.4 per cent of GDP in 2002 to 12.9 per cent of GDP in 2003[7], thereby giving impetus for further worsening of the current account deficit. In 2003, the government has introduced a fiscal consolidation programme which aims to reduce the general government deficit to 4 per cent of GDP in 2006. The fiscal consolidation will support further deficit

7 This deficit is partly due to one single imputed state guarantee, which is about 6.3 per cent of GDP.

reductions and assist in bringing the current account deficit in more sustainable territory if private net saving should become less favourable.

However, improvement in the quality of public finances will largely depend on the implementation of the fiscal reform. A very important feature of the fiscal reform is the modification of the institutional framework, with the introduction of the medium-term expenditure frameworks and performance-oriented budgets. In particular, the expenditure frameworks should diminish the central government's incentives to provide state guarantees, which remain a source of substantial fiscal risk. In addition, given the ongoing decentralisation of public administration, the lack of budgetary rules at regional and local levels represents a risk to a sound fiscal position in the future. As a positive development, it is worth mentioning that in its reform plans the government does not foresee a lowering of the share of public investment expenditures as a percentage of GDP in the coming years.

As far as the long-term sustainability of public finances is concerned, extra-budgetary spending and rapidly increasing social security and health care expenditures are reasons for major concern. Although the current level of government debt in the country is not high, developments regarding the items above contributed to a rapid increase in recent years (from 25.2 per cent of GDP in 2001 to 37.6 per cent of GDP in 2003).

Continue to address the structural problems in the labour market

Between 1990 and 2002 the Czech labour market experienced substantial structural changes. The share of people employed in the primary sector fell from 12.4 per cent to 4.8 per cent of the labour force, from 45.1 per cent to 39.6 per cent in the secondary sector and increased from 42.5 per cent to 55.6 per cent in the tertiary sector. The unemployment rate was 7.3 per cent at the end of 2002, and has since risen up to 8.1 per cent in the fourth quarter of 2003. In addition to the restructuring process, unemployment is likely to be affected by public finance reform, according to which 2 per cent of public sector jobs are to be lost annually over the period 2004-2006. The impact of trade unions on wage formation is low. The wage negotiation process is decentralised with wage setting mostly at the enterprise level. Bargaining coordination across firms and sectors is weak. Despite the fact that the employment rate is high (65.5 per cent in 2002) and the unemployment rate is around the EU average, the Czech labour market displays a number of structural shortcomings. First, regional disparities in unemployment are very high. The rate of unemployment in structurally weak regions is more than four times higher than in Prague and in some regions it exceeds 25 per cent. Second, the share of long-term unemployed (more than one year) is very high as it reached 40.3 per cent by the end of 2003. In addition, the average period of registration at the labour offices is becoming longer. Third, the rate of youth unemployment (people under 25 years old) is very high. The average share of youth unemployed was almost 23 per cent with substantial regional disparities.

On the labour supply side, long-term unemployment and low occupational flexibility stem from the disincentives embedded in the tax and benefit system, from the underdeveloped system of life-long learning programmes, and from shortcomings of the education and training systems. As regards the latter, they do not sufficiently provide skills that are adapted to the needs of the labour market, in particular to the demands of the knowledge-based economy. The structural shortcomings in the Czech labour market also mirror low geographical mobility, which results from two principal shortcomings: First, the regulation of housing prices weakens incentives for supply of housing in regions where jobs are created. And second, the weak transport infrastructure increases the costs of commuting and creates obstacles for investment and setting up of new enterprises in the structurally weak regions.

On the labour demand side, the high rate of health and social security contributions might have negative effects. The total rate of health and social security contributions has reached 47.5 per cent of gross wage of which about ¼ is paid by employees and about ¾ by employers.

Improve conditions for an accelerated productivity growth

Productivity growth in the Czech Republic has been comparatively low. Over the period 1996-2002, labour productivity grew by 2.1 per cent annually, the lowest rate among the new members. Moreover, the level of productivity is still very low in comparison with the EU (around 55 per cent of the EU 15 average in 2003). Factors contributing to this situation could be the limited flexibility of the education system, the low effectiveness of R&D and innovation, and the low use of ICT. The limited flexibility of the education and training system in responding to the changing skills requirements manifests itself through the qualification mismatches in the labour market. Educational attainment (the percentage of the population aged 20-24 with at least upper secondary education) is very high (92 per cent), but the share of tertiary graduates is one of the lowest in the EU. Despite a relatively high level of expenditure on R&D in comparison with the new members, the resulting innovation activity, as measured by the number of patents, is very low, pointing to low effectiveness of R&D. There seems to be only limited cooperation between the research institutions (e.g. universities and the Czech Academy of Sciences) and the private sector. Recognising these problems, the government has adopted the National R&D Policy for 2004-2008 to promote R&D but results will largely depend on its full implementation.

Promote entrepreneurship and SMEs

Despite the progress in establishing a well-functioning competition framework and continuous developments in the legal environment there seem to remain significant barriers to entrepreneurship in the Czech Republic. This is reflected *inter alia* in the low share of GDP accounted for by SMEs (less than 40 per cent). The gross-birth rate of enterprises as a percentage of all enterprises is relatively low in comparison with other new members.

Factors contributing to this situation appear to be the weaknesses in the business environment which have a disproportionately heavier impact on SMEs, e. g.

regarding regulations and legal enforcement, excessive administrative burden on companies and limited access to finances. The administrative process of setting up a new company is very lengthy and complicated. The ineffective and often non-transparent operation of the Commercial Register is frequently criticised by entrepreneurs. Also the bankruptcy legislation does not allow for effective market exit or restructuring of troubled companies. Several legislative proposals to tackle some of these problems are currently being prepared but the progress has proven to be slow. Notwithstanding improvements in the qualification of judges, the quality and timeliness of legal enforcement remain fundamental weaknesses. In addition, new businesses find it excessively difficult to find external sources of financing.

Country specific recommendations to the Czech Republic

Meeting the challenges outlined above requires broad structural reforms as they are laid down in the general guidelines (GL) in Part I of the Broad Economic Policy Guidelines.

In order to urgently ensure a further reduction of the general government deficit on a sustainable basis and the long-term sustainability of public finances, the Czech Republic is recommended to:

1. reduce the general government deficit in a credible and sustainable way within a multi-annual framework in line with the decisions to be taken by the Council in the context of the forthcoming budgetary surveillance exercise (GL 1).

2. reform the health care and pension systems to ensure their financial sustainability, in particular to counter the expected increase in the old-age dependency ratio and take measures to reduce fiscal risk stemming from the rising stock of contingent liabilities; and to ensure that incentives to work are enhanced and the high social security contribution rates are lowered (GL 4, 14 and 16).

In order to continue to address the structural problems in the labour market, the Czech Republic is recommended to:

3. strengthen labour supply by reforming tax benefit systems to eliminate disincentives to work and enhance occupational and regional mobility by reducing skill mismatches, whilst ensuring the efficiency of retraining measures and other active labour market policies, deregulating the housing market, and improving transport infrastructure (GL 4, 7, 8 and 13).

In order to improve conditions for an accelerated productivity growth, the Czech Republic is recommended to:

4. improve the efficiency and quality of the education and training system and its responsiveness to changing skills requirements (GL 13).

5. improve the efficiency of R&D and innovation activities, foster the transfer of knowledge through FDI and support the diffusion of knowledge (GL 13).

In order to promote entrepreneurship and SMEs, the Czech Republic is recommended to:

6. improve the business climate by, in particular, removing administrative burdens, improving and enforcing the legal framework and increasing access to finance (GL 11 and 12).

18. Estonia

Against the background of weak external demand, macroeconomic performance in Estonia remained solid in 2003, but the current account deficit widened to 13.7 per cent of GDP. GDP growth of 4.8 per cent was underpinned both by buoyant investment and private consumption growth. The latter was driven by strong credit expansion, higher wages and modest employment growth. Against the backdrop of a protracted investment sluggishness in the euro area, capital spending in Estonia grew briskly at over 11 per cent, due to strong FDI inflows and low interest rates. Inflation, which had accelerated to almost 7 per cent in mid-2001, receded to 1.3 per cent in 2003. The general government surplus widened to 1.8 per cent of GDP in 2002 and further to 2.6 per cent in 2003, on account of strong activity and improved tax collection, and despite additional spending approved by parliament. Some local governments continued to exert a drag on public finances.

Policies in Estonia should aim at achieving a high degree of sustainable convergence, and a narrowing of the current account deficit. Fiscal policy can have a significant impact on the current account, while structural policies, particularly those that aim at improving productivity and increasing competition, can raise the economy's growth potential, and in turn further improve the saving-investment balance and the current account. Additionally, the labour market, and specifically the high unemployment rate, remains an important challenge for the authorities following the restructuring of the economy after independence. Against this background, Estonia faces four major challenges:

- Address the sizeable current account deficit, to which an appropriate fiscal policy should contribute,
- Address the structural problems in the labour market,
- Improve conditions for increasing productivity,
- Develop effective competition in network industries.

Address the sizeable current account deficit, to which an appropriate fiscal policy should contribute

A mismatch between domestic and foreign demand was manifested in a robust demand for imports (8.1 per cent increase), and a relatively sluggish export performance (5.1 per cent increase), and consequently in a deterioration in the current account deficit to 13.7 per cent of GDP in 2003. A number of large one-off items, concerning mainly the import of investment goods, and a negative income balance accounted for a large part of the deficit, while the capital account remained in surplus, thanks to strong FDI inflows. The low level of public debt (around 5 per cent of GDP) and the positive credit rating of the country help to allay immediate stability concerns about the financing of the current account deficit. In addition, the central government has accumulated a “stability reserve” amounting to 9 per cent of GDP, which has been financed from budget surpluses and privatisation revenues since 1997.

Structural policies enhancing the external competitiveness of Estonian goods and services, primarily through a rapid improvement of the country's infrastructure as well as investment in human capital, with a particular focus on the country's disadvantaged regions, are therefore essential to decisively reduce this major macroeconomic imbalance of the Estonian economy in the medium-term.

The continuation of prudent fiscal policies plays a key role in addressing the current account deficit. While the general government surplus increased from 1.8 per cent of GDP in 2002 to 2.6 per cent of GDP in 2003, some local governments continued to exert a drag on public finances with budget slippages in both 2002 and 2003. Despite the fiscal surpluses of recent years and the low public debt, plans for additional expenditures and tax cuts along with commitments related to EU accession will make for higher budgetary pressure in the near future. This may lower national savings further and thus have a negative impact on the overall policy mix, particularly against the background of a very high current account deficit. On the whole, the Estonian general government balance should remain in balance or in surplus over the next few years, even with some fiscal easing. Moreover, an easing of fiscal policy over the first few years of EU membership is likely to coincide with an economic upswing. A pro-cyclical effect of the envisaged fiscal policy stance may not be ruled out. Thus, the implementation of the medium-term fiscal policy program in Estonia requires a prudent and flexible approach.

Address the structural problems in the labour market

Conditions in the labour market in Estonia have deteriorated gradually following the country's independence. The restructuring of the economy, and the resulting skill mismatch, appear to be the main factors behind the rise in unemployment to 14½ per cent by mid-2000 (based on the ILO definition). The employment rate which had declined from 65 per cent in 1997 to 60.6 per cent in 2000, edged up to 61.1 per cent in 2002 for the first time since the country's independence contributing to a turnaround in the labour market, resulting in a fall in the unemployment rate to 10.3 per cent in 2002. However, this improvement was the result of modest employment gains, and a significant decline in the economically active population; employment increased by some 2 per cent over 1997-2002 while the economically active population declined by almost 2.5 per cent.

The rising unemployment over 1997-2002 was associated with a steady increase in the proportion of long-term unemployed, and of discouraged workers, and consequently an increase in the structural unemployment rate. However, the share of those without a job for more than a year declined to 41 per cent of the unemployed in 2002, or almost to the same level as in 1997, after having increased considerably to 60 per cent during this period. Even so, the number of long-term unemployed remains particularly high, suggesting that a large number of the unemployed do not possess the skills required to reintegrate successfully into the labour market. Regional disparities continue to persist and unemployment remains considerably higher in the Northeast (at around 19 per cent of the labour force) than compared with the South (8½–9 per cent).

Improve conditions for increasing productivity

In Estonia, the level of productivity is still very low compared to the EU average (42 per cent of the EU 15 level in 2002). While labour productivity growth remained strong (7 per cent per annum) over the period 1997-2000, it has slowed down since 2000. Two main factors could constitute a handicap for future increases in productivity growth: the lack of qualifications in the workforce and the low level of R&D and innovation. These two factors also explain that FDI are mainly concentrated in areas that do not require important R&D and qualifications.

The lack of qualifications in the workforce results from inefficiencies in the education system, as public expenditures on education are relatively high (6.7 per cent of GDP in 2000). Particularly worrying is the fact that the education system is not sufficiently close to the needs of the labour market, creating a mismatch.

A well-designed R&D policy can also have an important role in increasing productivity growth. Currently Estonia has a relatively low level of R&D expenditures, below that of other European countries (0.8 per cent of GDP in 2001), and the lowest rate of business R&D among the new members. This is partly due to the weak links between the academic sector and the business community. In this area, a new strategy has been approved which foresees a significant increase in total R&D expenditures over the period 2002-2006.

Develop effective competition in network industries

While the liberalisation of network industries has started in Estonia, competition is still very limited in the electricity market. The country has negotiated a long transition period for the liberalisation of this sector, in light of its dependence on oil shale as a source of electricity generation. The restructuring of the oil-shale sector has started, but the progress made in the planned liberalisation of the market is limited. The electricity market is dominated by a State-owned, vertically integrated company with operations in supply, generation, monopoly transmission and distribution. The declared current market opening of 10 per cent, is below most of the other new member states' degree of market opening. One of the most important obstacles to liberalisation of the electricity market is the imposition of strict import licence rules by the authorities. Ensuring the independence of the energy regulator is also important given the State's ownership of the incumbent in the electricity market.

The problems are less acute in gas and telecommunication. The gas market is privatised and open, with a single supplier operating on the market. The telecommunication market has been also liberalised. However, some problems might arise because the owner of the network also operates as a distributor.

Country specific recommendations for Estonia

Meeting the challenges outlined above requires broad structural reforms as they are laid down in the general guidelines (GL) in Part I of the Broad Economic Policy Guidelines.

In order to address the sizeable current account deficit, to which an appropriate fiscal policy should contribute, Estonia is recommended to:

1. implement a fiscal policy that is in line with the decisions to be taken by the Council in the context of the forthcoming budgetary surveillance exercise (GL 1), and which is consistent with the objective of avoiding pro-cyclical policies that may exacerbate the external imbalance (GL 2).

In order to address the structural problems in the labour market, Estonia is recommended to:

2. adopt policies with particular emphasis on re-integrating the long-term unemployed, particularly in regions worst hit by the restructuring of the economy, by promoting vocational training and life-long learning, and by setting up an effective institutional framework that is supporting job creation (GLs 4, 6 and 8).

3. encourage social partners to ensure that wage developments—including changes to the minimum wage legislation—do not hinder employment growth, and hold up the recovery in the labour market (GL 3and 5).

In order to improve conditions for increasing productivity, Estonia is recommended to:

4. improve the efficiency and quality of the education system and vocational training in order to reduce the mismatch on the labour market (GL 13).

5. implement the R&D strategy approved in 2001 and, in particular, promote the stronger involvement of the business sector in R&D spending (GL 13).

In order to develop effective competition in network industries:

6. proceed with the liberalisation of the electricity market, strengthen the independence of the regulator and ensure effective competition in telecommunications (GL 9).

19. Hungary

Following a relatively high real GDP growth of 3.5 per cent in 2002, real GDP growth in 2003 slowed to below 3 per cent. While unemployment is among the lowest of the acceding countries, the participation rate is very low compared to the EU average. Serious structural shortcomings in the labour market render further increase in employment difficult: notably a lack of regional mobility, skill mismatches and disincentives from the benefit systems. Achieving a high degree of sustainable convergence requires regaining and maintaining competitiveness at a sustainable high level. A return to reasonable real wage development and the creation of a more investment-promoting environment seems therefore crucial in order to ensure a balanced medium-term growth.

After the high fiscal deficit of 9.3 per cent of GDP in 2002, fiscal policy became restrictive again in 2003. However, the general government deficit still reached 5.9 per cent of GDP. The significant overshooting of the fiscal deficit targets during the last two years contributed to the consumption-driven widening of the current account deficit to above 5 ½ per cent of GDP. Together with other problems in the macroeconomic policy mix (such as the high real wage growth and very high real interest rates) and the high volatility of the exchange rate, this has led to a general loss in financial markets' confidence and to a loss in overall competitiveness.

Policies in Hungary should aim at achieving a high degree of sustainable convergence, in particular as regards the consolidation of public finances. Hungary implemented a number of structural reforms and has achieved important catch-up with the EU. However there are areas which pose further challenges to the country. Hungary should aim to adopt measures in order to make the education system more effective and R&D has to be encouraged in order to achieve higher productivity. Competition in the network industries needs to be further improved and the independence of the regulators has to be strengthened. Against this background, Hungary faces five major challenges:

- Ensure a further reduction of the general government deficit on a sustainable basis,

- Increase employment rates and address the structural problems in the labour market,

- Enhance cost-competitiveness by pursuing policies that induce wage moderation,

- Improve conditions for increasing productivity,

- Develop effective competition in network industries.

Ensure a further reduction of the general government deficit on a sustainable basis

After the high deficit of 9.3 per cent of GDP in 2002, fiscal policy became restrictive in 2003. However, the general government deficit of 2003 was still 5.9 per cent of GDP. While for 2004 a further reduction of the deficit is foreseen, the starting position for the achievement of the 2004 deficit target seems rather difficult. While initially aiming at comprehensive public finance reforms, a significant number of expenditure items have not been addressed at all in the budget of 2004, and still seem not to have been considered in the consolidation plans. Meanwhile, savings are intended to result mainly from cuts in current and operational expenses. The previous expansionary fiscal stance, along with high real wage growth, contributed to high domestic demand and an increasingly consumption-driven widening of the current account deficit, to somewhat above 5½ per cent of GDP. A reduction in the high government sector level of borrowing is also crucial in order to improve the current account. Households' savings can not be expected to be sufficient to finance the rise in private investment (including those related to EU accession). This is expected to put further pressure on the current account. Even maintaining the present current account deficit, while allowing investment to take place, would thus require additional budgetary constraint. A return to sustainable policies in Hungary has to be based on a consolidation of public finances.

Increase employment rates and address the structural problems in the labour market

Hungary has one of the lowest unemployment rates among the acceding countries (5.8 per cent in 2003). However, this is accompanied by a stagnating labour force and a low participation rate (59.7 per cent in the 15-64-year age-bracket for 2002) compared to the EU average. Consequently, the low unemployment rate does not reflect the substantial disengagement from the labour market and the high level of inactivity particularly in the end-of career working age population.

The labour market is also characterised by structural shortcomings. Regional differences can mostly be observed in the form of increasing urbanisation and the East-West axis, with a less developed infrastructure and higher unemployment in the Eastern part of the country. Internal mobility is low in international comparison, with housing and transport as the main impediments. Furthermore, a significant number of unemployed are young adults (the youth unemployment rate is 11.4 per cent).

Enhance cost-competitiveness by pursuing policies that induce wage moderation

While showing a slight improvement since the beginning of 2003, Hungary's cost competitiveness has shown a significant deterioration in the years 2000-2002. The decline in cost competitiveness was partly due to the fast increase in wages. Real wage growth exceeded productivity growth in the last three years, led by a rise in minimum wages and by the public sector, but also by a delayed adaptation of the corporate sector to the new low-inflation environment. Although wage growth slowed down towards the end of the year, real wages still grew by 9.2 per cent in 2003 (with 7.3 per cent in the business sector and 12.7 per cent in the public sector). They have negatively influenced cost-competitiveness, and led to decreasing employment in some low-skill segments of the labour market. While this process has contributed to a change in the structure of industrial production towards high skilled labour, increasing unit labour costs have led to a deterioration in the overall competitive position of the country, not just in labour-intensive activities.

Improve conditions for increasing productivity

Productivity growth has been decreasing since 2000, although it remained slightly above the average of the new Member States. While labour productivity growth was 4.2 per cent in 2000 it decreased to 2.4 per cent in 2003. Factors contributing to the slowdown in productivity growth have been the relatively low level of R&D (0.95 per cent of GDP in 2001), inefficiencies in the education system, and instability in the business environment.

While some measures have been taken to improve the flexibility of the education system in order to better adapt to the changing needs of the labour market, there is still a lack of “middle-skilled” and high-skilled workers in the labour market. The number of PhD students is increasing but many terminate their studies before obtaining their diploma. The number of total tertiary graduates in science and technology per 1000 of population (aged 20-29) has been decreasing during the last years: in 2001 it was 3.7 which is one of the lowest in the EU. In the field of research and development, applied research is lagging behind, partly due to the still low level of business R&D expenditures, despite fiscal incentives, and limited cooperation between companies and research institutes. Public R&D expenditures are also relatively low, not only as a share of GDP but also as a share of total government expenditures (R&D expenditures by the government represented 0.9 per cent of total government expenditures in 2001). Another factor which might negatively affect productivity growth is the frequently shifting policy environment. Regulations and government strategies have often been changed during the last decade, which reduced the predictability of policies and trust in the government, and hampered longer term planning.

Develop effective competition in network industries

While liberalisation has started in most of the network industries, effective competition is still limited in these sectors. One of the most liberalised markets is telecommunication. However, even in this market, competition is restricted due to the strong dominant position of the previously State owned enterprise in the fixed line market and the quasi duopoly situation on the mobile market. Electricity and gas markets have been opened up for big customers. However, long-term purchase agreements and the low availability of interconnection capacities continue to pose obstacles to competition in electricity. Finally, in certain of these sectors the State has retained its capabilities to intervene in the activities of the network regulators. This is the case in the electricity and gas markets where the government has the possibility to influence prices.

Country specific recommendations to Hungary

Meeting the challenges outlined above requires broad structural reforms as they are laid down in the general guidelines (GL) in Part I of the Broad Economic Policy Guidelines.

In order to ensure a further reduction of the general government deficit on a sustainable basis, Hungary is recommended to:

1. reduce the general government deficit in a credible and sustainable way within a multi-annual framework in line with the decisions to be taken by the Council in the context of the forthcoming budgetary surveillance exercise (GL 1).

In order to increase employment rates and to address the structural problems in the labour market, Hungary is recommended to:

2. strengthen labour supply by removing obstacles to regional mobility through appropriate measures in the housing and transportation policy, and by encouraging disadvantaged groups (ethnic minorities, disabled and homeless people) to (re-)enter the labour market (GL 7 and 8).

3. ensure that the tax and benefit systems support employment and provide incentives to enter or remain in the labour market (make work pay- principle) – the high tax burden of labour force should be further reduced (GL 4).

In order to enhance cost-competitiveness by pursuing policies that induce wage moderation, Hungary is recommended to:

4. encourage a reform of wage setting which allows wages to better reflect productivity. Promote multi-annual wage agreements with the social partners in order to keep real wage development in line with productivity growth (GL 5).

In order to improve conditions for increasing productivity, Hungary is recommended to:

5. promote the stronger involvement of the private sector in R&D and innovation, strengthen the link between business and research institutions, ensure sufficient resources to improve the quality of

research and support the transfer of knowledge through FDI (GL 13).

6. improve the efficiency of the education system, increase its flexibility in order to better adapt to the skill needs of the market and ensure adequate resources for vocational training and education (GL 13).

7. ensure stability of legislation and government policies to create a business environment, more supportive to entrepreneurship (GL 11).

In order to develop effective competition in network industries, Hungary is recommended to:

8. proceed with the liberalisation of the network industries, increase effectiveness of competition and the independence of the network regulators (GL 9).

20. Latvia

Robust economic performance was registered in Latvia in recent years despite a weak external environment. It is expected that GDP growth will remain at potential growth of 5-6 per cent per year in the medium term. Private consumption and gross fixed capital formation have been particularly strong and are the driving factors for growth. Despite high private consumption growth, inflation remained modest over the last five year. However, inflation is expected to reach relatively high levels this year; but could fall to 3 per cent by 2006/07. External trade has expanded rapidly and since imports are outpacing exports, the current account deficit has increased to 9.1 per cent of GDP in 2003 and is expected to remain at this high level in the medium term. Latvia made remarkable progress implementing structural reforms in recent years, but still faces some challenges, including the functioning of the public administration, that could impair Latvia's absorption of EU structural funds. These challenges if not fully met, may weaken Latvia's ability to stay on a path of strong growth.

The unemployment rate declined slowly and varies considerably across regions. The smooth functioning of the labour market is hampered by a number of structural problems, including inadequate education and training systems, skills mismatches and low geographical mobility. Competition on Latvian product markets has been boosted by the privatisation of most State-owned companies, and the level of State aid remains lower than the EU average. The few remaining competition problems are mainly concentrated in network industries. Although Latvia benefits from low labour costs and taxes, the low level of labour productivity remains a major concern.

The decreasing trend in the general government deficit was interrupted in 2002, when it rose to 3 per cent of GDP, from 1.6 per cent in 2001. In 2003 better than expected tax revenues and close monitoring of expenditure by the government helped to reduce the general government deficit to 1.8 per cent of GDP and in 2004 the deficit is planned to be 2 per cent of GDP. However, Latvia's fiscal position depends on the strength of the commitment to ensure budgetary discipline; consequently, a pro-cyclical stance characterizes Latvia's fiscal policy. On the other hand, the general government debt remains low at 15.6 per cent of GDP.

Policies in Latvia should aim at achieving a high degree of sustainable convergence, in particular as regards the consolidation of public finances. Both the further consolidation of public finances and solutions to address the under-utilisation of Latvia's human resources need to be supported by policies which assist in perpetuating the strong growth performance into the medium and long term. This requires in particular a strengthening and diversification of the growth and employment base by fostering the entrepreneurial climate. Furthermore, the productivity level needs to be raised and Latvia should prepare for the eventual transition to a knowledge-based economy. Against this background, Latvia faces four major challenges:

- Address the sizeable current account deficit, to which an appropriate fiscal policy should contribute,
- Improve conditions for increasing productivity,
- Address the structural problems in the labour market,
- Develop effective competition in network industries.

Address the sizeable current account deficit, to which an appropriate fiscal policy should contribute

Latvian domestic demand for imported goods remains stronger than the external demand for Latvian goods, thus, the current account deficit has increased to 9.1 per cent of GDP in 2003. Export growth in 2002 and 2003 was very strong despite the international slowdown; however, imports grew even faster than exports. In the next few years the trade balance is expected to worsen even more, because of strong and growing investment needs as the economy continues to develop and restructure. This will lead to a broadening of the current account deficit. Although export prices grew faster than import prices in 2003, the terms of trade do not show consistently favourable developments over the last years, thus adding uncertainty regarding potential future pressures on the current account.

The modest pace of fiscal consolidation was disrupted by fiscal slippage in 2002, despite strong economic growth of the Latvian economy. In 2003, the general government deficit is estimated to be 1.8 per cent of GDP. This owes mainly to better-than-expected tax revenues, following both improvements in tax collection and a higher-than-expected growth. Even though the Latvian authorities maintain a commitment to balancing the budget in the medium term, the current pro-cyclical fiscal stance, combined with rapidly a changing political scene and a rather limited ability of the government to increase tax revenues in a period of high economic growth, put Latvia in a difficult position from which to meet future spending needs. These spending pressures are also likely to exacerbate the current account deficit. In the face of a weak external demand and already high domestic demand, a spending surge in late 2002, strong credit growth, in spite of the Central Bank of Latvia's interest rate increases in November 2003 and again in March 2004, and further fiscal loosening are a cause for concern. The key economic policy challenge is to avoid a pro-cyclical fiscal stimulus that could overheat domestic demand and aggravate the current account deficit.

Improve conditions for increasing productivity

Labour productivity in Latvia is the lowest in the EU (under 40 per cent of the EU-15 average). Over the period 1995-2003, it has increased relatively to the EU average but its growth rate slowed down in recent years. Several factors bear on Latvia's productivity performance. First, although reforms have been initiated, the educational system still suffers from efficiency, contents, and external partnerships problems, and the links between higher education and industries are still underdeveloped. Second, despite fiscal and other indirect measures taken R&D – in particular the share of business R&D - and innovation activities appear to be limited, both because of a lack of public funding and the absence of critical mass for most Latvian companies to carry out research activities. Productivity growth is also constrained by the low level of entrepreneurial activity as companies face heavy local regulations, difficulties in accessing finance, and a nascent entrepreneurial culture. Despite high levels of business investments, productivity levels are still held back by low capital deepening and a still relatively low level of physical infrastructure. All these factors also contribute to explain why Latvia remains specialised in relatively low-tech sectors and in transit activities without much value-added.

Address the structural problems in the labour market

The Latvian labour market displays a number of structural shortcomings, the main being high regional differences in unemployment, and a high share of long-term unemployment and youth unemployment. In 2002, the participation rate reached 68.8 per cent and the employment rate was 60.5 per cent. The unemployment rate was 12.1 per cent at the end of 2002 and has declined in 2003.

The smooth functioning of the labour market is hampered by a number of structural problems. First, the under-utilisation of human resources stems from feeble entrepreneurial climate. Latvia has the lowest rate of business start-ups in the EU, which underlines the necessity to facilitate entrepreneurship and the development of small and medium size enterprises, in this way fostering the employment base. Second, the labour tax wedge is high in Latvia and creates a disincentive to work in the official economy. In addition, given the low wages, even modest social benefits make working or returning to work costly decisions and therefore discourage labour market participation. Third, the high rate of unemployment reflects to some extent skills mismatches between labour supply and demand. Moreover, the education system fails to meet the demand for more flexible and modern forms of training. The Latvian authorities have recently proposed a comprehensive reform of the education system to better adapt it to the requirements of a market economy, however, implementation of the reform might be both costly and lengthy. Finally, regional discrepancies in employment and unemployment are also the result of low geographical mobility, which could be enhanced through improvements in transport infrastructure.

Develop effective competition in network industries.

Steps to liberalise network industries have only been recently taken place with full liberalisation of voice telecommunications in 2003 and progressive liberalisation of other network industries to comply with EU legislation. All network industries are still dominated by the respective incumbents - some of them being gradually privatised – facing low effective competition and benefiting from the absence of a real choice of supplier. Low effective competition has several sources. In some cases, technical and practical barriers impede competition to develop, as is the case in telecommunications, where local loop unbundling, carrier selection and number portability are trailing behind. In some other cases, the legal base for more effective competition is not yet fully in place, such as in energy. One additional source of low effective competition is a lack of interconnection. Latvia's railways connections are not well-developed with Baltic neighbours and other European countries. In gas, the Latvian market is still dominated upstream by very few importers and is *de facto* dependent on Russian gas supply. Finally, cross-border interconnections in electricity between Baltic States and other Member States may be insufficient to cope with long-term demand.

Country specific recommendations to Latvia

Meeting the challenges outlined above requires broad structural reforms as they are laid down in the general guidelines (GL) in Part I of the Broad Economic Policy Guidelines.

In order to address the sizable current account deficit, to which an appropriate fiscal policy should contribute, Latvia is recommended to:

1. reduce the general government deficit in a credible and sustainable way within a multi-annual framework in line with the decisions to be taken by the Council in the context of the forthcoming budgetary surveillance exercise (GL 1 and 2).

In order to improve conditions for increasing productivity, Latvia is recommended to:

2. increase the efficiency, quality and accessibility of the education and training systems, and their responsiveness to the labour markets' needs (GL 13 and 14).

3. encourage R&D and innovation, in particular in the business sector (GL 13 and 14).

4. encourage an entrepreneurial culture (GL 11).

In order to address the structural problems in the labour market, Latvia is recommended to:

5. revise the tax and benefit system in order to make work pay more, in particular by increasing the efficiency of social spending (GL 4).

6. strengthen labour supply by pursuing efforts to better adapt the qualifications of the workforce to the requirements of the labour market and by facilitating labour mobility, especially through improvements in transport infrastructure (GL 7 and 13).

In order to develop effective competition in network industries, Latvia is recommended to:

7. take legal measures to enhance effective competition in network industries and to strengthen the role of the regulator (GL 9).

8. increase physical interconnections with other European networks (GL 9).

21. Lithuania

In spite of a weak external environment, Lithuania's macroeconomic performance remained particularly strong in the last two years. Real GDP growth accelerated rapidly to 8.9 per cent in 2003, primarily supported by strong investment and private consumption, although export growth remained robust. A large nominal effective appreciation of the litas, together with strong productivity growth that attenuated wage inflation, led to a decline in price levels. The decline (measured in HICP) amounted to 1.1 per cent in 2003. Strong economic growth was positively reflected in the labour market, although high unemployment remains as a major weakness in the Lithuanian economy.

The decreasing trend in the general government deficit initiated in 2000 was interrupted in 2003, when the deficit increased slightly to 1.7 per cent of GDP, from 1.4 per cent in 2002. Significant increases in both current and capital expenditure, partly associated with EU accession related expenditure, are approved in the budget for 2004 and are expected to result in a further rise of the deficit. Fiscal consolidation is expected to resume in 2005. Moderate budget deficits in previous years have contributed to maintaining sustainable current account deficits, which have to a large extent been financed by foreign direct investment. The currency board arrangement has proved a successful nominal anchor for monetary policy, contributing to macroeconomic stabilisation and historically low inflation rates. The enhanced macroeconomic stability has allowed for a decreasing trend in interest rates in the last few years, contributing to high domestic credit growth and consequently to rapid growth of investment and consumption.

Policies in Lithuania should aim at achieving a high degree of sustainable convergence. The labour market is a source of concern. Decreasing the high unemployment rate and a further consolidation of public finances will be crucial to enhance macroeconomic stability in the medium term. Preserving Lithuania's competitiveness will be of paramount importance for a rapid and sustained convergence with the EU economies. Further structural changes will be necessary to maintain the current productivity growth trend, which is required to close the substantial productivity gap between Lithuania and the EU average. In this regard, adapting the education system to the needs of the labour market and developing R&D and innovation are required to facilitate much-needed progress towards the transition to the knowledge-based economy. Against this background, Lithuania faces four major challenges:

- Address the structural problems in the labour market,
- Maintain low general government deficits,
- Improve conditions for increasing productivity,
- Develop effective competition in network industries.

Address the structural problems in the labour market

Despite visible improvements in the labour market in the last two years, the unemployment rate remained high at 12.7 per cent in 2003 and major structural weaknesses persist. Large regional disparities are evident, with several regions recording unemployment rates around 20 per cent. The youth unemployment rate remained high at 23 per cent in 2002, whereas the long-term unemployment rate stood at 7 per cent. Close to 17 per cent of employment lies in the low-productivity agricultural sector, where significant labour shedding is likely to take place and exert upward pressure on unemployment in the next years.

Major structural shortcomings in the labour market are related to the limited occupational and geographic mobility of the workforce, mismatches between supply and demand of skills and education deficiencies. Despite enjoying high participation rates in higher education, professional qualifications of the Lithuanian workforce are often specialised in areas that do not match properly the current demand for skills. Labour shortages are emerging in the areas of information technologies, management and several categories of engineering. Enhancing the links between educational institutions and business would help to better adapt vocational training and tertiary education to the current needs. At the same time, lifelong learning activities, which are essential to increase the workforce's capacity to adapt to future demands, are currently at one of the lowest levels among the acceding countries. Further efforts to improve the quality and availability of vocational training would be beneficial, especially in the least developed regions. The high share of low-qualified workers in unemployment calls for special attention to training activities for this category of workers. Improving the educational infrastructure, particularly in poorer regions, would contribute to establishing better framework conditions for attracting investment and increase the workforce's capacity and willingness to move. Further efforts to improve the business environment would help to create employment and offset redundancies stemming from industrial and agricultural restructuring. The unemployment benefits system needs to be streamlined, the size of unemployment benefits are not linked to previous wages, coverage of the insurance is not clearly defined in the legislation and the links between the contributions and benefits of the unemployment insurance system are unclear.

Maintain low general government deficits

The authorities have held to their fiscal consolidation plans. Accordingly, the general government deficit decreased from 5.7 per cent of GDP in 1999 to 1.4 per cent in 2002. However, the deficit reversed its decreasing trend and picked up slightly to 1.7 per cent in 2003. Against the background of higher revenue collection than expected in the first half of 2003, the government decided to allocate additional expenditure by means of a supplementary budget in July 2003. The amendments resulted in significant increases in current expenditure that prevented a further reduction of the deficit in 2003, mainly in the form of compensations for the loss of rouble savings[8] (about 0.4 per cent of GDP) and agricultural subsidies (0.2 per cent of GDP). The 2004 budget foresees a further increase of the deficit, largely related to a surge in public investment and higher expenditure related to the social security system and public sector wages, as well as significant transition costs of the pension reform. Spending pressures stemming from high investment needs and sizeable fiscal obligations and contingent liabilities denote a risk for the consolidation of public finances in the medium-term.

Despite efforts made to improve the tax system, there is considerable room for improvement as regards the efficiency of tax collection. Government revenues as a percentage of GDP have decreased from 38.1 per cent in 1998 to 33.8 per cent in 2002, while expenditure has remained largely stable. Additional expenditure to the budget plans is frequently allocated in the second half of the year, which prevents a faster consolidation of public finances. A pro-cyclical fiscal policy stance could entail some risks as additional spending pressures are intensifying. Although low budget deficits have contributed to alleviate pressures on the current account in the last years, fiscal policy might need to play a role in mitigating a potential deterioration of the private sector's savings-investment balance, which could be stimulated by the present rapid credit growth dynamics.

Improve conditions for increasing productivity

Lithuania has had high productivity growth after the Russian crisis in 1999, but the productivity level is still very low at 42 per cent of the EU 15 average. Also the recent high productivity growth seems to have been partly caused by one-off effects due to better capacity utilisation of existing resources. With a GDP per capita level at 39 per cent of the EU 15 average in 2002 a high and sustainable productivity growth is necessary to reduce the income gap with the EU. In this respect, deficiencies of the education system and the low level of R&D and innovation are a handicap.

Firstly, despite high public spending on education and a high number of tertiary graduates there is a mismatch between the skills acquired in the education and training systems and the needs in the business sector as described in the first key challenge. The government is preparing a program for the implementation of an education strategy stretching to 2012, but further efforts may be necessary to adapt the education and training systems to the future needs as the economic structure develops. Secondly, a large share of the current economic structure is based on low technology activities. A change of the structure will require higher R&D and more innovation, which currently are among the lowest in the new Member States. Maintaining high levels of FDI could act as a catalyst through knowledge transfer and thereby contribute to faster structural changes in the economy towards higher

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[8] The government committed to compensate citizens for the loss of rouble savings in the first years of transition and to restitute ownership rights or pay pecuniary compensations for real estate property confiscated during Soviet times. The outstanding amounts to be paid accounted for about 6.7 per cent of GDP at the end of 2003.

value-added sectors and improved productivity. Further development of the physical infrastructure could also contribute to maintaining the high productivity growth. IT expenditure has increased slightly from a very low level and low IT penetration could be a hindering factor for improving productivity.

Develop effective competition in network industries

Despite deregulation in most network industries, effective competition remains weak in all of them, except mobile telephony and road transport. The fixed telephony market was fully liberalised in January 2003, but the incumbent is still the only player in the market. The telephone market regulator does not yet seem to have adequate resources to effectively promote competition. The implementation of the EU legislation on railway market opening has not yet been completed and the infrastructure is poorly developed, especially the interconnections with Poland.

The opening-up of the energy markets have led to few visible benefits for consumers and high concentration ratios persist, both in supply and distribution. The electricity market was opened-up for large customers in January 2002, corresponding to a fourth of the electricity consumption. Further deregulation is foreseen in steps and a privatisation of electricity distributors is currently underway. However, about 80 percent of all electricity is produced by a nuclear power plant and a lack of interconnection capacity with other acceding countries prevents integration with the EU electricity market. Also the gas market has been liberalised for large customers, corresponding to 80 per cent of consumption. However, there are few independent players in the market and there is no interconnection with the Western European gas network.

Country specific recommendations to Lithuania

Meeting the challenges outlined above requires broad structural reforms as they are laid down in the general guidelines (GL) in Part I of the Broad Economic Policy Guidelines.

In order to address the structural problems in the labour market, Lithuania is recommended to:

1. enhance regional mobility and reduce skill mismatches, whilst ensuring the efficiency of education, retraining measures and other active labour market policies (GL 4, 7 and 8).

2. improve the combined incentive effects of taxes and benefits (GL 4).

In order to maintain low general government deficits, Lithuania is in particular recommended to:

3. pursue low budget deficits in a credible and sustainable way within a multi-annual framework in line with the decisions to be taken by

the Council in the context of the forthcoming budgetary surveillance exercise (GL 1).

4. avoid pro-cyclical fiscal policies that prevent a further reduction of the general government deficit, in particular by avoiding budget amendments that allocate additional expenditure in response to higher than expected revenues (GL 2).

In order to improve conditions for increasing productivity, Lithuania is recommended to:

5. improve the efficiency and quality of the education and training systems and their responsiveness to labour market needs (GL 13).

6. promote R&D and innovation, strengthen the links between research institutes and the business sector and support knowledge transfer through FDI and higher IT penetration (GL 13).

In order to develop effective competition in network industries, Lithuania is recommended to:

7. pursue liberalisation and enforce effective competition in energy, telecommunication and railway markets (GL 9).

8. create and improve interconnection capacities with neighbouring EU Member States (GL 9).

22. Malta

The increasingly open nature of the Maltese economy, large dependence on tourism revenues and its small size make the economy increasingly vulnerable to external economic and geopolitical shocks. The difficult international economic environment in the last two years and restructuring of the public sector brought about modest economic growth, mostly fuelled by large public consumption. Real GDP growth is currently far below its estimated potential.

Despite sluggish economic growth, unemployment did not increase substantially in the period January-October last year (5.7 per cent in October 2003), although some deterioration is expected in subsequent months, linked to the restructuring in the shipyard industry and in the manufacturing and tourist sectors. Malta's general progress in adopting the *acquis* has not been accompanied by the accomplishment of crucial economic reforms against the backdrop of accession to the EU in May 2004. The restructuring of the public sector and reduction of state aid and subsidies and the reform of the pension and healthcare systems have been postponed, resulting in a negative impact on economic growth, employment generation and public finance. The comparatively low employment rate, particularly among women, remains a cause of concern. In a context of little efforts to consolidate public finances, lower than expected GDP growth in 2003 and mounting public expenditure have further deteriorated the general government deficit, placing pressure on the current account balance. Policies in Malta should pursue a high degree of sustainable convergence, in particular as regards the consolidation of public finances. With this aim in mind, momentum in the reform of the pension and healthcare systems, and public sector has to be regained. Despite some progress, the degree of competition in some areas remains insufficient and privatization efforts need to be pursued. Against this background, Malta faces three major challenges:

- Ensure a reduction of the general government deficit on a sustainable basis and the long-term sustainability of public finances,

- Increase employment rates, especially among women,

- Encourage effective competition taking into account the specific characteristics of the small domestic economy.

Ensure a reduction of the general government deficit on a sustainable basis and the long-term sustainability of public finances.

In order to tackle the high general government budget deficit of 9.7 per cent of GDP in 2003, the government plans to implement a series of measures and to strengthen tax enforcement to boost revenue. It is interesting to note that non-tax revenues are expected to grow faster than tax revenues. This is primarily due to the revenue collected under the foreign registration scheme and due to the EU Budgetary Compensations in the framework of the Copenhagen Package. Regarding direct taxation, some reduction is planned due to the introduction of a five-tier tax band (until now, three-tier band) and the increase in the threshold of income to be taxed.

On the expenditure side, high outlays for public sector wages, pensions and health care expenditure are a risk for the sustainability of public finances. Regarding current expenditure, higher control of appropriations of welfare benefits and other assistance programmes, in addition to a reduction in subsidies are desirable. However, due to persistent needs in modernising and building of new infrastructure, capital expenditure may keep the overall expenditures at a high level (around 50 per cent of GDP), although a fall is foreseen in 2006 (to 46.6 per cent of GDP).

The population ageing implies a significant fiscal risk to the long-term sustainability of public finances, in particular due to a relatively high level of government debt. The expected rapid increase in the old-age dependency ratio between the years 2000 and 2050 (from 18 per cent to 38.6 per cent) is to exert significant fiscal pressure on public finances in the future. While a reform of the 1st pillar of the pension scheme is being planned, it is unclear when it is going to be implemented.

The substantial level of outstanding state guarantees (22 per cent of GDP in 2002) is menacing the government's fiscal position. The government plans to limit the issuance of the new guarantees in the future (a decline in the stock to 15 per cent of GDP in 2006), which is to be done by a stricter enforcement of the budgetary rules governing the issuance of the guarantees. This should contribute to the planned medium-term decline in the level of the implicit contingent liabilities and alleviate the existing risk exposure, arising from the issued letters of comfort or credit facilities. Overall, the general government gross debt amounted to 72 per cent of GDP in 2003.

Increase employment rates, especially among women

In Malta, the labour market seems to be sufficiently flexible to adjust to economic shocks without generating long periods of high unemployment. However, in September 2003 the employment rate (53.7 per cent) was low compared to the EU average. The relatively low employment rate was attributable to a low female employment rate (33.1 per cent) as the equivalent male figure (74.2 per cent) was higher than the EU average. The increase in total and female employment rates is of paramount importance to widen the base for social security contributions, in the light of the ageing population. In this respect, some measures to encourage female participation have been recently undertaken.

As the government realizes the importance of raising female participation in a scenario of falling birth rates and an ageing population, initiatives aiming at increasing the female participation rate are included in the Employment and Industrial Relations Act (ERA), which came into force in December 2002 and was complemented by eight legal notices (one of those concerns the Parental Leave Entitlement Regulation). Other initiatives in this field are a Childminding Scheme, a Gender Equality Action Plan and gender mainstreaming in the public service. Furthermore, the accomplishment of the privatization process and the trimming of the public sector may contribute to a more efficient deployment of resources to the advantage of the private sector and boost economic efficiency and employment.

High taxes on wages distort both demand and supply for labour, while activity is diverted to the informal economy. The gap between the minimum wage and unemployment benefit, especially for the larger families, remains very low and reduces incentives to work. Early retirement schemes used as a means to restructure public sector entities should be also limited, efforts being directed towards re-training. The ERA also regulates part time employees and contracts of services for a fixed term in order to increase flexibility in the labour market. Vocational education activities have increased since 2001, when the Malta College for Arts, Science and Technology was set up, although further efforts should be made to both improve the success rate in secondary education and reduce the number of early school leavers. Three new institutes in the fields of Mechanical, Engineering, Agribusiness and Community Services have been created in 2003. It is important to note the exceptionally high level of lower secondary education attainment, and very low attainment at upper secondary and tertiary levels.

Encourage effective competition taking into account the specific characteristics of the small domestic economy

A significant number of reforms have been introduced to increase competition in the Maltese economy. In the network industries, the telecommunication sector is now liberalised, whilst the postal services sector is being opened-up. In air transport, the monopoly of groundhandling activities has been removed following an international call for tenders. Concerning the maritime transport, the implementation of the *acquis* has to be completed. In some sectors of the Maltese economy, competition is weak, such as the wheat milling and feed grains, and the shipbuilding sector, where state aids have to be reduced in conjunction with the restructuring process.

Country specific recommendations to Malta

Meeting the challenges outlined above requires broad structural reforms as they are laid down in the general guidelines (GL) in Part I of the Broad Economic Policy Guidelines.

In order to ensure a reduction of the general government deficit on a sustainable basis and the long-term sustainability of public finances, Malta is recommended to:

1. reduce the government deficit in a credible and sustainable way within a multi-annual framework in line with the decisions to be taken by the council by the context of the forthcoming budgetary surveillance exercise (GL 1).

In order to increase employment rates, especially among women, Malta is recommended to:

2. streamline the tax-benefit system interaction to strengthen the incentives to work and reduce taxation on labour to improve its competitiveness (GL 4).

3. improve the quality of secondary education and vocational training (GL 8).

4. strengthen retraining of labor to make it more adaptable in the case of labor-shedding and facilitate the return to work of middle-age women (GL 8).

In order to encourage effective competition taking into account the specific characteristics of the small domestic economy, Malta is recommended to:

5. pursue the efforts to increase competition in certain sectors such as network industries, food industries, and shipbuilding (GL 9).

23. Poland

After a record of strong growth during most of the 1990s, Poland experienced a sharp economic slowdown in 2001-2002. Since the end of 2002, the recovery has gradually gained strength, and real GDP growth accelerated to 3.7 per cent in 2003. In 2004, growth is likely to reach its potential level estimated at around 4.5 per cent.

Despite remarkable progress in recent years, Poland still faces serious structural problems that may impair its capacity to stay on a path of strong growth. The unemployment rate has increased rapidly since 1999 and is now, at about 20 per cent, the highest among the acceding countries. In parallel, the employment rate has fallen markedly and almost half of the working age population is without work. The smooth functioning of the labour market is hampered by a number of structural problems, including limited responsiveness of wages to labour market conditions, disincentives from the tax and benefit system, skills mismatches and low geographical mobility.

Poland's fiscal position has deteriorated significantly since 2000, as a result of both cyclical factors and the relaxation of fiscal policy. The general government deficit increased from 1.8 per cent of GDP in 2000 to 3.6 per cent in 2002. Until recently, the authorities have shown some reluctance to tackle the fiscal problems, including the rapidly rising debt ratio. The public finance reform adopted by the government early this year envisages substantial spending cuts but postpones the needed fiscal adjustment until 2005.

Policies in Poland should aim at achieving a high degree of sustainable convergence, in particular as regards the consolidation of public finances. Moreover, stability-oriented macroeconomic policies need to be complemented by structural reforms aiming at improving Poland's growth performance. In addition to the under-utilisation of human resources, the relatively low productivity level limits the capacity of the Polish economy to increase both actual and potential output growth. To address this issue, continued efforts are needed to improve the education and training system and also to create favourable conditions for R&D and technology transfer. In addition, the economy, in particular the agriculture sector, calls for more restructuring and there is room to improve the business environment. Against this background, the challenges facing Poland are to:

- Urgently address the deep-seated structural problems in the labour market,
- Ensure a reduction of the general government deficit on a sustainable basis and the long-term sustainability of public finances,
- Improve conditions for increasing productivity,
- Speed up the restructuring of the economy and accelerate privatisation in industry,
- Improve the business environment.

Urgently address the deep-seated structural problems in the labour market

Poland has the highest unemployment rate (19.8 per cent in 2002) and the lowest employment rate (51.5 per cent) among the acceding countries. The employment rate is exceptionally low among elderly people and young people. In addition, the Polish labour market displays the following features: a high youth unemployment rate, a high long-term unemployment rate, significant differences across regions and a high share of unemployed in rural areas.

The smooth functioning of the labour market is hampered by a number of structural problems. First, the concentration of unemployment in particular regions and among certain groups reflects in part the imperfect adjustment of wages to regional differences in productivity and individual skill levels. The wage-setting process lacks flexibility and in particular has proved so far ineffective in imposing wage discipline in state-owned enterprises and in the general government sector. In addition, the nationally-set minimum wage is high relative to average wages in many regions and hence contributes to the persistence of high unemployment among young and low-skilled workers.

Second, the labour tax wedge is high in Poland and creates a disincentive to work in the official economy. In addition, the combined effects of tax and benefit systems make working or returning to work a costly decision and therefore discourage labour market participation. Tightening the eligibility criteria for disability pensions and phasing out early retirement benefits would be a first step towards increasing the attractiveness of work.

Third, the high rate of unemployment reflects to some extent skills mismatches between labour supply and demand. Moreover, education levels in the adult population are relatively low. The Polish authorities have recently launched a comprehensive reform of the education system to better adapt it to the requirements of a market economy. Finally, regional discrepancies in employment and unemployment are also the result of low geographical mobility, which could be enhanced through reforms of the housing market and improvements in transport infrastructure.

Ensure a reduction of the general government deficit on a sustainable basis and the long-term sustainability of public finances

Poland's fiscal position has deteriorated significantly since 2000, only partly for cyclical reasons. The general government deficit reached 3.6 per cent of GDP in 2002 and is estimated to have increased further to 4.1 per cent in 2003. The fiscal expansion over the last two years is to a large extent due to a loosening of the fiscal stance. Fiscal policy is expected to remain pro-cyclical in 2004. The government has recently adopted a public finance reform which provides for savings in social spending and administrative expenditure over the period 2004-2007. However, there remains uncertainty with regard to the approval of the full fiscal reform package by Parliament. Reining in the government deficit is also crucial to maintain the current account deficit at sustainable levels, especially in case the current savings-investment surplus of the private sector should diminish sharply in the coming years.

The deterioration of fiscal accounts together with the slowdown in privatisation has resulted in a sharp increase in the government debt ratio since 2001. Although still relatively low by international standards, the debt level is rapidly rising and approaching the thresholds that trigger corrective mechanisms under the fiscal rules laid down in the Polish Constitution and the Public Finance Act. In view of the government's growing borrowing needs, the exposure of the budget to foreign exchange risk and risks stemming from contingent liabilities, debt dynamics is a major matter of concern.

Contingent liabilities constitute potentially a serious risk to the sustainability of public finances. State-owned companies in the sectors in need of restructuring are an important source of such liabilities. The stock of outstanding guarantees is rapidly increasing and will put pressure on public finances in the coming years.

The demographic structure in Poland is still relatively favourable. Nevertheless, the pension system underwent a major reform in 1999in order to adjust it to the demographic and labour force changes and to counter the consequences of the expected sharp increase in the old-age dependency ratio (from 18 per cent in 2000 to 50 per cent in 2050).

Improve conditions for increasing productivity

Despite reasonable productivity gains over the period 1995-2002, labour productivity per person employed (in PPS) in Poland was less than half that of the EU15 in 2002 and below the average of the new Member States. The catching-up process is therefore not satisfactory yet. This relatively low productivity level may be explained by various factors.

First, there is the high share of employment in agriculture, a sector with particularly low productivity levels. The difficulty of new firms to grow and the lack of mobility may be slowing down the transition of workers from agriculture to other activities. Second, Poland remains below the EU15 average in terms of investment in ICT and R&D. The low level of business investment in R&D is particularly problematic (only 30 per cent of the total R&D expenditure is financed by firms). Reasons cited include insufficient cooperation between research establishments and business and the fact that for firms short-term financial considerations tend to override long-term interests. An increase in the skills of the workforce is also to be achieved by promoting tertiary education and life-long learning. The low productivity is indeed related to the structural problems in the labour market, particularly a mismatch between skills taught in the education system and those required by the market place, together with a need for investment in physical infrastructure.

Speed up the restructuring of the economy and accelerate privatisation in industry

After a slow start, privatisation peaked in 2000 (as testified by a peak in FDI of 5.7 per cent of GDP which was boosted by a few large one-off privatisation transactions), but it has slowed down again since then, as the most attractive assets have been sold. The traditional sectors remain state-owned (among others mining, chemicals, defence sectors and railway). In these sectors, the Polish government has favoured a policy of consolidation before privatisation with the aim of creating "national champions" able to compete on EU markets. The pressure to limit short-term social disruption and the substantial consultation required with social partners and several ministers slow down the privatisation process. As a result, the attractiveness of firms to be privatised is considerably reduced, often deterring potential investors. Yet, there is evidence that the FDI inflows have contributed to restructuring the manufacturing sector and improved the export capacity and distribution networks. This is partly because, following privatisation, strategic investors have injected substantial equity capital and know-how into their firms which has resulted in large productivity gains.

The liberalisation of the electricity and gas sectors has started. Local and long-distance telecommunication services were fully liberalised in January 2002 and international services since January 2003. However, the level of competition in network industries is not satisfactory. In the gas sector, there is currently no unbundling at all. In telecommunications, the incumbent has retained its dominant position in the market. Prices for international calls are among the highest. Moreover, the Competition Office has repeatedly found the incumbent guilty of using its dominant position to the disadvantage of competitors.

State aid remains high (in form of tax and social security arrears) and state-owned firms have large debts to other companies, damaging those companies' finances. With respect to the enforcement record, shortcomings have been identified in the handling of rescue and restructuring aid as well as research and development aid.

Improve the business environment

Poland has made substantial progress in developing a large SME sector thanks to recent reforms. In particular, a new enterprise register is being set up, which creates a "one-stop shop" for firms from January 1, 2004. Since January 2004 a single 19 per cent corporate tax is also in application. Finally, a new solvency law was adopted in 2003 bringing the bankruptcy framework in line with the requirements of a modern market economy. The SME sector accounts for around two-thirds of employment and half of GDP and exports in Poland. However, SMEs continue to face difficulties in growing. Despite the recent reforms to support entrepreneurship, the firm size remains small and the entrepreneurship environment can still be improved. This is due to the lack of human capital, the lack of labour mobility, the underdeveloped infrastructure (especially the road and telecommunication networks), the high tax-burden (social security contributions in particular) and the liquidity constraints. These factors limit company creation and growth. Therefore, there are concerns that the problems just mentioned may reduce Poland's attractiveness to foreign investors (FDI).

Country-specific recommendations to Poland

Meeting the challenges outlined above requires broad structural reforms as they are laid down in the general guidelines (GL) in Part I of the Broad Economic Policy Guidelines.

In order to urgently address the deep-seated structural problems in the labour market, Poland is in particular recommended to:

1. increase the flexibility of the wage-setting process to ensure that wages better reflect differences in productivity across skills, firms and regions (GL 5).

2. lower the tax burden on labour, together with efforts to widen the tax base on labour and to improve the efficiency of the tax collection and enforcement system, and reform the tax and benefit systems to eliminate financial disincentives to work, in particular high inactivity traps for married couples, and to increase the efficiency of social spending (GL 4).

3. strengthen labour supply by pursuing efforts to better adapt the qualifications of the workforce to the requirements of the labour market and by removing obstacles to regional mobility, especially through reforms of the housing market and improvements in transport infrastructure (GL 7 and 13).

In order to ensure a reduction of the general government deficit on a sustainable basis and the long-term sustainability of public finances, Poland is recommended to:

4. reduce the general government deficit in a credible and sustainable way within a multi-annual framework in line with the decisions to be taken by the Council in the context of the forthcoming budgetary surveillance exercise (GL 1 and 2).

5. monitor the reform of the pension system to counter the expected increase in the old-age dependency ratio, and take measures to reduce the fiscal risk stemming from the rising stock of contingent liabilities (GL 15 and 16).

In order to improve conditions for increasing productivity, Poland is recommended to:

6. pursue and reinforce efforts to improve the efficiency and quality of the education and training system and its responsiveness to changing skills requirements (GL 13).

7. promote R&D and innovation, in particular in the business sector, and support the transfer of knowledge through FDI (GL 13).

In order to speed up the restructuring of the economy and accelerate privatisation in industry, Poland is recommended to:

8. reduce the overall level of State aids, whilst reorienting aid towards horizontal objectives (GL 9 and 14).

9. encourage market entry and effective competition in network industries while pursuing a greater connectivity of national markets (GL 9).

In order to improve the business environment, Poland is recommended to:

10. continue reducing administrative burden, simplifying regulation and supporting the growth of SMEs, in particular, by improving access to finance (GL 11).

24. Slovakia

After a stabilisation-induced slowdown in 1998, Slovakia's real GDP growth has steadily accelerated and exceeded 4 per cent in 2003, for the second year in a row. Nevertheless, output has not yet fully reached its estimated potential.

The growth performance has been underpinned by intensified structural reforms. Prime examples were the restructuring and privatisation in the banking and non-financial sectors. However, this did not come without cost: the unemployment rate ratcheted up to more than 19 per cent in 2001 and still amounts to around 17 per cent. A broad array of structural shortcomings in the labour market – notably a lack of regional mobility, disincentives from the benefit systems, wage inflexibilities, and skill mismatches – have been hampering its re-absorption capacity and are only being tackled now.

Public finance reforms have been very limited until recently as well and the general government deficit was 5.7 per cent of GDP in the election year of 2002. The expansionary fiscal stance contributed to a domestic demand boom and an increasingly consumption-driven widening of the current account deficit to more than 8 per cent of GDP. The government in office since 2002 has started to tackle the root causes of the fiscal deficit, thus supporting a significant narrowing of the current account deficit in 2003.

Policies in Slovakia should aim at achieving a high degree of sustainable convergence, in particular as regards the consolidation of public finances. Both the further consolidation of public finances and solutions to the under-utilisation of Slovakia's human resources need to be supported by policies which assist in perpetuating the strong growth performance into the medium and long term. This requires in particular a strengthening and diversification of the growth and employment base by fostering the entrepreneurial climate through an improved legal framework and judicial and administrative capacity building. Furthermore, the productivity level needs to be raised and Slovakia should prepare itself for its eventual transition to a knowledge-based economy. Against this background, Slovakia faces four major challenges:

- Ensure a further reduction of the general government deficit on a sustainable basis,
- Continue to address the deep-seated structural problems in the labour market,
- Improve the business environment and support entrepreneurship,
- Improve conditions for increasing productivity.

Ensure a further reduction of the general government deficit on a sustainable basis

The general government deficit decreased from 5.7 per cent of GDP in 2002 to 3.6 per cent of GDP in 2003, thereby supporting a significant narrowing of the current account deficit. The major part of a comprehensive agenda of public finance reforms has already been passed. These reforms will support further deficit reductions and assist in keeping the current account deficit in sustainable territory if private net saving should become less favourable again. The scope and speed of reforms have been remarkable. However, they also lead to non-negligible uncertainties with respect to the budget execution in 2004 and beyond. Risks stem in particular from the fundamental nature of the tax reforms, notably the introduction of a flat income tax rate of 19 per cent for corporates and individuals. These reforms make revenue forecasts relatively uncertain. Uncertainties also remain on the expenditure side, including with respect to further health reform measures.

Continue to address the deep-seated structural problems in the labour market

Slovakia has one of the lowest employment rates (around 57 per cent) and the second highest unemployment rate (currently around 17 per cent) in the acceding countries. Employment is particularly low in the age group over 55. Unemployment is concentrated among the young (below 24) and the low skilled. Regional disparities are high. The underlying structural deficiencies of the labour market are multi-faceted and are now being addressed more decisively.

Incentives to work and to leave the informal sector are being strengthened by social benefit and pension reforms, including an increase of the retirement age to a still relatively low level of 62. Regional mobility is being enhanced by financial support for commuters and housing benefits but continues to be limited as the transport infrastructure and the functioning of the housing market improve only gradually. Skill mismatches hinder in particular the reintegration of the long-term unemployed, although retraining measures are being intensified. A still low alignment of the education system with the requirements of a market economy contributes to persistent youth unemployment.

Job creation has been fostered by recent amendments to the labour code, which allow more flexible work relationships. However, the wage setting mechanism is not yet flexible enough and does not sufficiently cater for enterprise-specific conditions. In particular, the possibility of administrative extensions of collective wage agreements to enterprises that have not participated in the negotiations runs counter to this goal. In addition, minimum wages may have negative effects on labour demand and may insufficiently reflect local labour market conditions.

Slovakia's far-reaching income tax reform, effective since the beginning of 2004, will strengthen both job creation and the willingness to work. In contrast, the combined health and social contribution rates have only been lowered to a still very high level of almost 48 per cent of gross salary.

Improve the business environment and support entrepreneurship

Over the recent years, the government has introduced a number of measures aimed at improving the business environment. The procedure for setting up a new business has been significantly simplified and shortened. New bankruptcy legislation is being prepared that should replace the current system under which bankruptcy proceedings last excessively long and allow virtually no scope for the restructuring of troubled companies. The business environment was further strengthened by, for example, the substantial acceleration in price liberalisations in 2003 and the introduction of a new collateral law.

Despite these improvements, there still seem to be important barriers to entrepreneurship in Slovakia. The gross-birth rate of new enterprises is relatively low. According to business surveys, the degree of legal uncertainty remains a fundamental weakness. This stems from the often insufficient and unstable legislative framework and, in particular, weak legal enforcement, which frequently suffers from lack of quality, timeliness and transparency.

Improve conditions for increasing productivity

While retaining relatively high labour productivity growth, the level of productivity is still low (around 58 per cent of the EU average in 2003). Factors contributing to this situation are the lack of flexibility of the education system, coupled with low education expenditures and the weak R&D and innovation activity.

The education system does not seem to respond appropriately to the labour market needs. This is particularly the case for secondary schooling which often produces graduates with obsolete skills. Moreover, the share of tertiary graduates is very low. The high share of long-term unemployed poses an additional challenge for the vocational and training programmes. Furthermore, expenditure on education has dropped to one of the lowest levels among the new Member States in 2001. Responding to these problems, the government has taken first steps towards rationalising the system, improving its efficiency and increasing the sources of financing.

In 2002, the expenditures on R&D accounted for only 0.59 per cent of GDP, less than in most of the acceding countries. Innovation activity, as measured by the number of patent applications, is very low. The government has undertaken some measures to improve the situation regarding R&D (e.g. by improving the legislative framework for R&D), and is committed to increasing the public resources available for R&D support.

Country specific recommendations to Slovakia

Meeting the challenges outlined above requires broad structural reforms as they are laid down in the general guidelines (GL) in Part I of the Broad Economic Policy Guidelines.

In order to ensure a further reduction of the general government deficit on a sustainable basis, Slovakia is recommended to:

1. reduce the general government deficit in a credible and sustainable way within a multi-annual framework in line with the decisions to be taken by the Council in the context of the forthcoming budgetary surveillance exercise (GL 1).

In order to urgently continue to address the deep-seated structural problems in the labour market, Slovakia is in particular recommended to:

2. strengthen labour supply by removing obstacles to regional mobility and by reducing skill mismatches, whilst ensuring the efficiency of retraining measures and other active labour market policies (GL 4, 7 and 8).

3. generate additional labour demand by allowing for more flexibility in the wage setting mechanism (GL 5 and 18).

4. lower the very high combined health and social contribution rates, while observing the overall budgetary consolidation constraints, in particular by additional health system reform measures and by considering additional adjustments in the pay-as-you-go pillar of the pension system, in particular a further increase of the retirement age (GL 4 and 16).

In order to improve the business environment and support entrepreneurship, Slovakia is recommended to:

5. strengthen the legislative framework supportive to entrepreneurship and improve its enforceability by, in particular, adopting the new bankruptcy legislation and increasing the capacity and transparency of the judicial system (GL 11 and 12).

In order to improve conditions for increasing productivity, Slovakia is recommended to:

6. improve the efficiency and quality of the education and training system and its responsiveness to changing skills requirements (GL 13).

7. encourage R&D and innovation and support the transfer of knowledge through FDI (GL 13).

25. Slovenia

Over the last decade, Slovenia has exhibited stable growth; real GDP has grown steadily at 3-5 per cent since 1993. After a recent slow-down, GDP growth is expected to pick up and gradually draw closer to the potential output growth, estimated at around 4 per cent.

Despite a broadly sound economy and commendable achievements in many policy areas, certain weaknesses remain. Unexpected shortfalls have led to the repeated introduction of supplementary budgets in recent years. However, general government deficits are relatively small and fiscal consolidation seems currently to be well on track. While having declined steeply in the last two years, relatively high inflation (5.7 per cent in 2003) is still a cause of some concern and has been recognised as a key policy challenge. The government designed an apt policy to lower inflation in a sustainable way, aiming to create conditions to be able to fully reap the benefits of EU accession. It has pursued structural reforms with the objective to facilitate price liberalisation. Currently, administered prices represent 16 per cent of the CPI – the lowest share of all the acceding countries. However, given ineffective competition in the utilities, and insufficient flexibility in both in the financial sector and the labour market a sustainable reduction of inflation still needs to be confirmed.

The restructuring process of the economy has negatively affected the situation on the labour market; employment in manufacturing industry fell markedly over the period 1996-2000. A shift of labour from this sector to the service sector buffered the economic and social distress, while early retirements were used to attenuate a rise in total unemployment. Although the overall picture concerning the labour market in Slovenia is positive, structural unemployment problems persist. The proportion of long-term unemployment is high, in particular amongst older, low-skilled persons. Furthermore, the low employment rate of workers over 55 years of age is a cause of concern, especially with regard to the challenges stemming from an ageing population.

In order to create the necessary job opportunities and facilitate participation in the labour market, leading in turn to a further improved economic performance in the future, continued efforts to promote entrepreneurship, to stimulate the innovative capacity of the business sector and to enforce effective competition in all segments of the economy are required. Policies in Slovenia should aim at achieving a high degree of sustainable convergence. Against this background, Slovenia faces four major challenges:

- Lower inflation in a sustainable way,
- Increase employment rates, especially for older workers,
- Improve conditions for sustained productivity growth,
- Promote the development of effective competition in all segments of the economy, notably in network industries.

Lower inflation in a sustainable way

Although decreasing, inflation remains relatively high. For 2003, the rate of inflation stood at 5.7 per cent, down from 7.5 per cent a year before. The ongoing decline is an encouraging development, although it seems partly attributable to special factors – related to ceilings on administered price rises and indirect taxes as well as frequent adjustments of excise duties on oil. Inflationary pressure continues to be fed by lack of competition in various sectors, inflexible labour markets, and still widespread indexation mechanisms. Furthermore, other important factors contribute to inflation's perseverance; an accommodating monetary policy and a steady, but now slowing, depreciation of the currency, in particular, add to inflation inertia.

In the run-up to EU accession, the government made inflation a policy priority and adopted a co-ordinated anti-inflation policy measures accordingly. A comprehensive price control plan was enforced, regulating the administered price rises and tax changes in a way not to exceed the inflation rate at the end of the year. As regards the objective of proceeding towards a generalised de-indexation of the economy, a step forward was made in 2003 with the official abolition of interest rate indexation (the 'basic interest rate' or TOM) and the social agreement on a new wage adjustment method. A forward-looking indexation has already been introduced for public sector wages, taking effect in July 2004, whereas for the private sector such a policy yet needs to be negotiated. Moreover, the public finance stance needs to be adjusted flexibly. Also, a more swift implementation of structural reforms is necessary for a sustained disinflation and an improved economic performance.

Increase employment rates, especially for older workers

The employment rate in Slovenia – with 63.4 per cent in 2002, close to the EU average – is one of the highest among the acceding countries. Also, the unemployment rate – decreasing steadily since 1998 to have reached 6.0 per cent in 2002 – ranks amongst the lowest in the group. Nevertheless, its long-term component is high at around 60 per cent, principally among older, low-skilled workers over 55 years of age. With other structural imbalances present in the labour market (youth unemployment, unemployment of disabled persons, gender unemployment gap, low educational level of the unemployed, high regional disparities) to increase employment of elderly has been identified as a particular important challenge. In 2002, the unemployment rate for persons aged 55-64 was 3 per cent, while the employment rate stood at 24.5 per cent, a figure very low compared to the EU average of 40.1 per cent. This is a consequence of the low retirement age, which in 2001 averaged only 57 years. The restructuring of the economy has pushed relatively young individuals into retirement (or unemployment). As a result of the pension reform introduced in 2000, the retirement age has already slightly increased. However, the impact of this reform will only gradually be reflected in a higher employment rate for older persons. A large gap between the employment rates for older workers in Slovenia and the EU is expected to persist.

The main orientation of the employment policy is thus to address the problems of unemployment for elderly people and to stimulate active forms of increasing their employability. This is particularly important in view of the growing risks of financial unsustainability resulting from unfavourable demographic developments. The old-age dependency ratio is expected to rise from 20 per cent in 2000 to 38 per cent in 2025 and 66 per cent in 2050. Furthermore, the promotion of work and active working life is the necessary precondition for combating poverty and social exclusion.

Improve conditions for a sustained productivity growth

The level of productivity, while the second highest amongst the new Member States, remains well below the EU-15 average (69.5 per cent in 2003). Labour productivity growth in Slovenia was relatively rapid over the period 1995-1999, with an average annual rise of 4.8 per cent. However, it decelerated thereafter (2 per cent on average in 1999-2002), placing Slovenia amongst the least performing acceding countries in this period of time. Two elements may hamper a more rapid development in productivity:

First, the entrepreneurial activity of the active population remains relatively low, notably because the administrative burdens affecting both business creation and existing businesses are still high. Efforts have already been made to simplify procedures for start-ups. However, the business legislation and administrative environment could be further improved since bureaucratic and lengthy procedures as well as difficulties in buying land for industrial use still persist.

Second, there is a lack of effectiveness of R&D expenditure to build on relatively good achievements in basic research in terms of transfer of know-how to the business sector, of patenting and of product or process innovation. With R&D expenditures reaching 1.6 per cent of GDP in 2001, Slovenia ranks first amongst the new Member States but still remains below the EU average, despite strong growth in direct public funding of R&D and the introduction of fiscal incentives for business R&D. Slovenia also ranks first amongst the new Member States in terms of patent applications with the European Patent Office, but its performances in this field (41 per million inhabitants in 2001) are well below the EU average. In addition, the share of researchers employed in the business sector is low as compared to the public sector (one-third and two third respectively) and innovative activity appears to be weak in the high tech sector.

Promote the development of effective competition in all segments of the economy, notably in network industries.

Slovenia has proceeded towards increasing liberalisation in product markets and in network industries, but effective competition needs to be enhanced. In particular, while the Competition Protection Office is mandated with adequate powers to exercise control over restrictive agreements and any abuse of dominant position and mergers, its administrative capacities both in terms of financial and human resources are insufficient to ensure its proper functioning. Moreover, the current legislation does not allow it to set deterrent fines on anti-competitive behaviour.

In recent years, Slovenia has started liberalising its network industries. In telecommunications, legal market opening was introduced in 2001 and an independent regulatory agency was created in 2002. However, effective competition has not yet appeared in fixed telephony for inland calls where the incumbent still holds 100 per cent of market share. The high price of network interconnections together with regulated low price levels for both local and national calls are the main barriers to the entry of new operators in fixed telephony. As regards the energy sector, large electricity customers (66 per cent of electricity consumption in Slovenia) are free to choose their supplier and since 2002 the largest ones are allowed to purchase electricity from abroad. However, the scope of international exchanges is limited to a maximum of 20 per cent of total electricity consumption. In gas, the largest consumers are since 1 January 2003 free to choose their own supplier (accounting for 50 per cent of gas consumption in Slovenia), but in practice they can not switch to another supplier because of long-term contracts up to 2007 with the incumbent.

Country specific recommendations to Slovenia

Meeting the challenges outlined above requires broad structural reforms as they are laid down in the general guidelines (GL) in Part I of the Broad Economic Policy Guidelines.

In order to lower inflation in a sustainable way, Slovenia is recommended to:

1. step-up structural reforms aimed at liberalising administered prices and advance further with de-indexation, in particular of the wage setting mechanism (GL 5).

In order to increase employment rates, especially for older workers, Slovenia is recommended to:

2. review the tax and benefit systems, with a focus on labour market participation of older workers, and reassess the measures promoting active ageing by means of lifelong learning activities, as well as address the imbalance between temporary and permanent work conditions (GL 4, 8).

In order to improve conditions for sustained productivity growth, Slovenia is recommended to:

3. further reduce the time and costs necessary to set up a new company and simplify the administrative procedures affecting businesses (GL 11).
4. promote R&D and innovation in the business sector and improve the quality of the tertiary level education system (GL 13).

In order to promote the development of effective competition in all segments of the economy, notably in network industries Slovenia is recommended to:

5. strengthen the administrative capacity of the Competition Protection Office, ease the entry of new competitors in network industries, and facilitate the purchase of lands for industrial use (GL 9).