

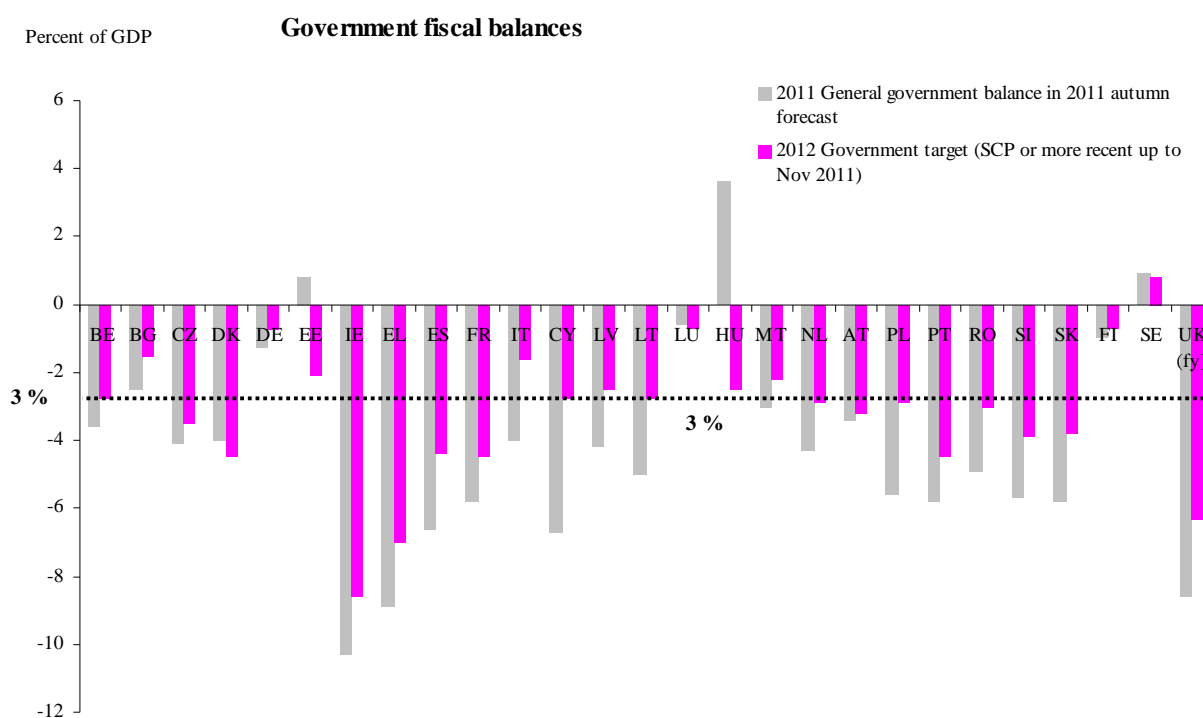
Issues Paper

In the context of the European semester, the March European Council gives, on the basis of the Commission's Annual Growth Survey, guidance to Member States for the Stability or Convergence Programmes and National Reform Programmes to be submitted by each Member State in April. As described in the Presidency's synthesis report on the European Semester, progress is lagging in a number of key areas where reform is essential to promote growth and jobs. Furthermore, the recent Alert Mechanism Report by the European Commission points to possible challenges and risks raised by macroeconomic developments in some Member States. The stagnation of economic activity in 2012, as projected by the latest Commission interim forecast, also highlights the necessity of serious action to revive growth across Europe.

The objective of the discussion in the European Council is thus **to identify the priorities Member States should focus on in the preparation of their National Reform Programme and Stability or Convergence Programme**. The Commission's Annual Growth Survey has identified a number of key priorities for 2012. Some of them, such as restoring normal lending to the economy, requires action at the EU level and are being addressed. Others require action at Member State level. This paper aims to highlight these through a number of illustrative, though non-exhaustive charts and figures. Of course, by definition, these illustrations are partial in nature. Moreover, they will not capture some of the more recent reform measures and actions taken in some Member States. But given the scale of the economic challenge Europe faces, their underlying message remains pertinent.

1. **Fiscal consolidation**

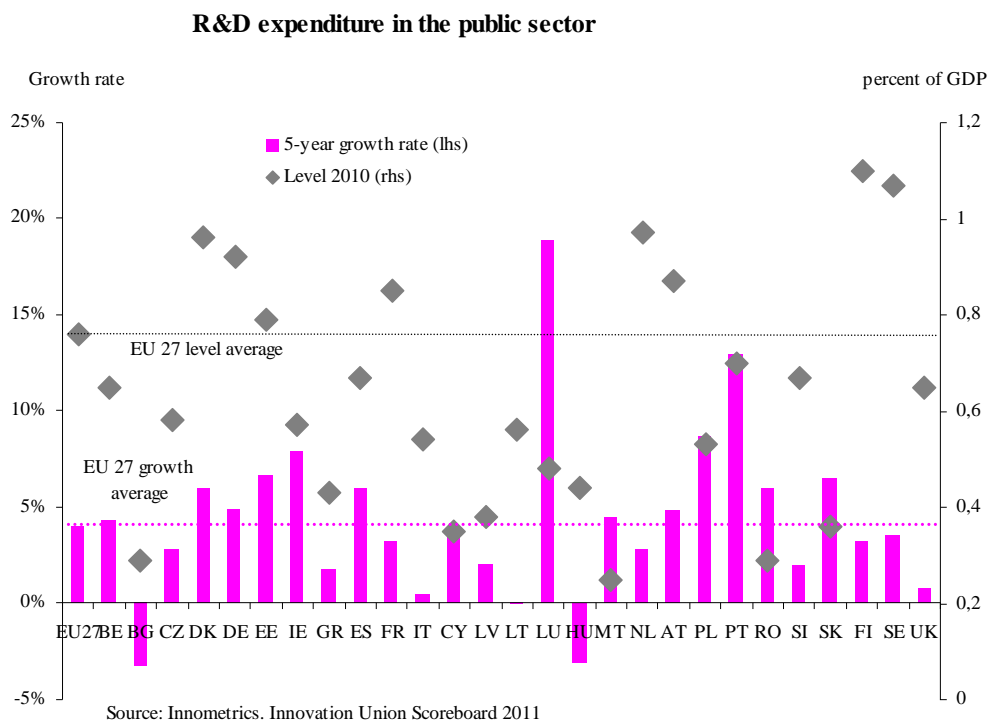
Progress has been made, but, given structurally weak fiscal positions in several Member States, fiscal consolidation needs to be pursued in earnest. Member States benefiting from financial assistance programmes have been leading fiscal efforts, with Greece, Portugal and Ireland recording changes in the structural balance above 5 percent of GDP since 2009. Looking ahead, as previously agreed, differentiated strategies should be pursued and implemented within the common framework, taking account of country-specific fiscal and macro-financial risks. Countries under an assistance programme or market scrutiny should stick to agreed targets, whilst those with more fiscal space should let automatic stabilisers operate fully. The following graph, based on the Autumn 2011 Commission forecast, highlights the challenge, as showing the distance between the then projected 2011 fiscal deficit, Member States' 2012 targets and the three percent deficit limit.



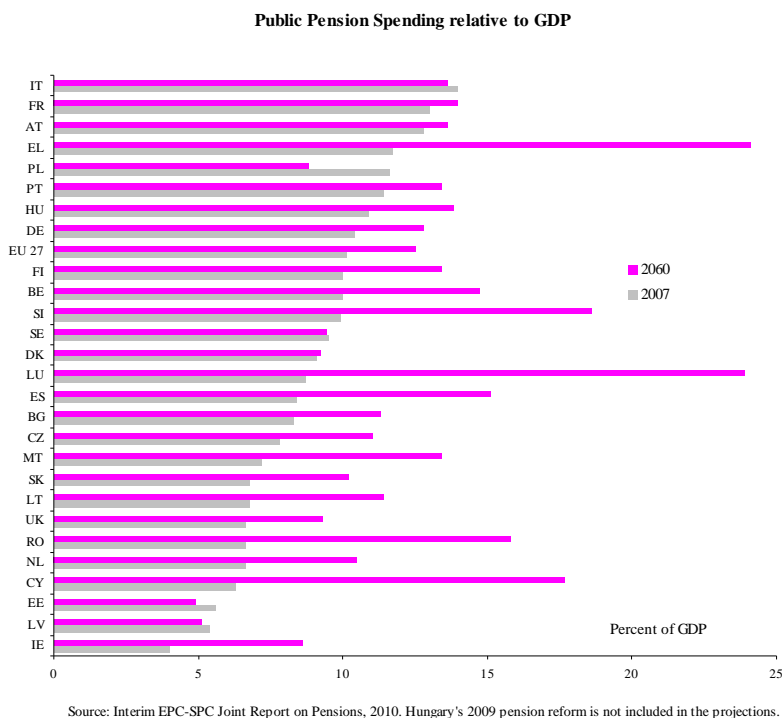
Source: Commission Services

To ensure growth-friendly consolidation, Member States should pay particular attention to the following elements:

- **Prioritizing growth-friendly expenditure**, such as education, research and innovation, which are an investment in future growth, and ensuring the efficiency of such spending. Nordic countries, for example, seem well positioned as regards the level of public investment on R&D. For many Member States, however, prioritization on R&D remains a challenge.



- **Pursuing the reform and modernization of pension systems**, respecting national traditions of social dialogue, to ensure financial sustainability and adequacy of pensions. After reforms over many years, a number of Member States anticipate only moderate increases of public pension expenditures, but for some, without further reform, the projected change could be substantial or the level could remain elevated. (For example, the chart suggests that in Luxembourg, Cyprus, Greece, Romania, Slovenia, or Spain public pension expenditure could rise by more than 6 percentage points as a share of GDP over the next fifty years. Latest reforms in Greece,

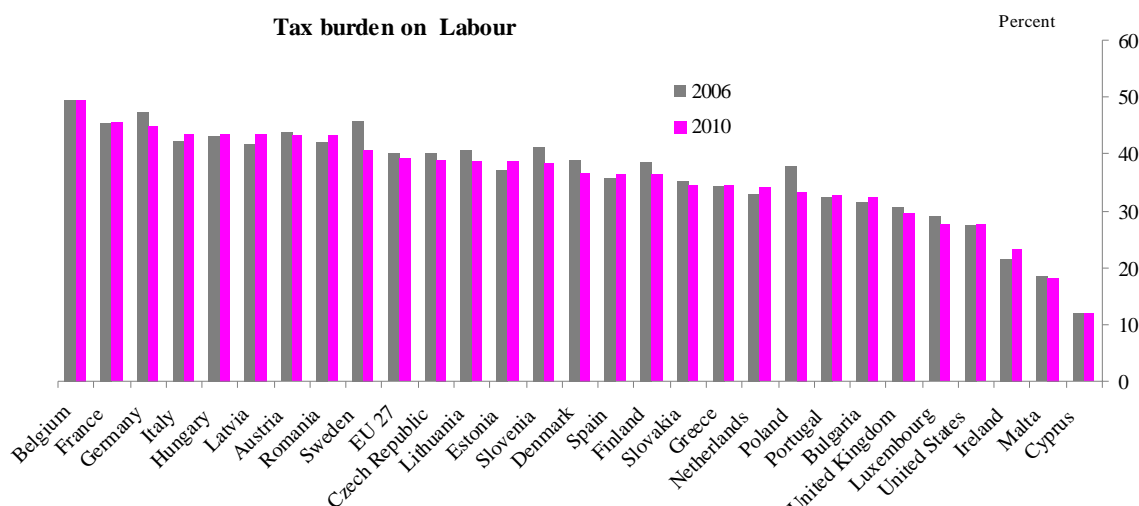


Romania, Spain are likely, however, to have lowered these estimates.) The modernisation of pension systems should be coupled with a reform of health systems aiming at cost-efficiency, sustainability and a more healthy labour force to lift labour participation.

- **Growth-friendly national tax policies.** This can be achieved via:

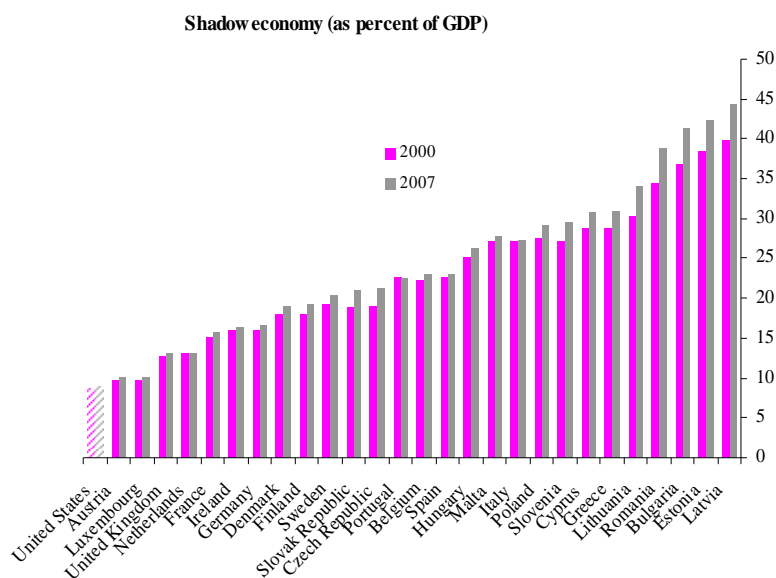
- **Reducing distortive high tax rates, including by a broadening of the tax base.**

- **Reducing the tax burden on labour**, especially on low income earners. This seems to be a challenge for most Member States, with only Ireland, Malta, Luxembourg or the UK reporting a tax burden below 30 percent, which is close to the average of OECD countries. While in some parts of Europe, developments have been encouraging, in others, budgetary pressures during the crisis drove up the tax-related cost of labour.



Source: European Commission. As 2010 data is unavailable for Cyprus, the data point for 2010 refers to 2007. The tax burden is measured as the difference between the before- and after-tax wage for an employed person with low earnings.

- **Improving the efficiency of tax collection and tackling tax evasion to increase government revenue**, including through agreements with third countries based on a coordinated approach where relevant. Measures to encourage moves from informal or undeclared work to regular employment should be reinforced. Gains from doing so appear large in Southern and Eastern Europe and the Baltic Countries.



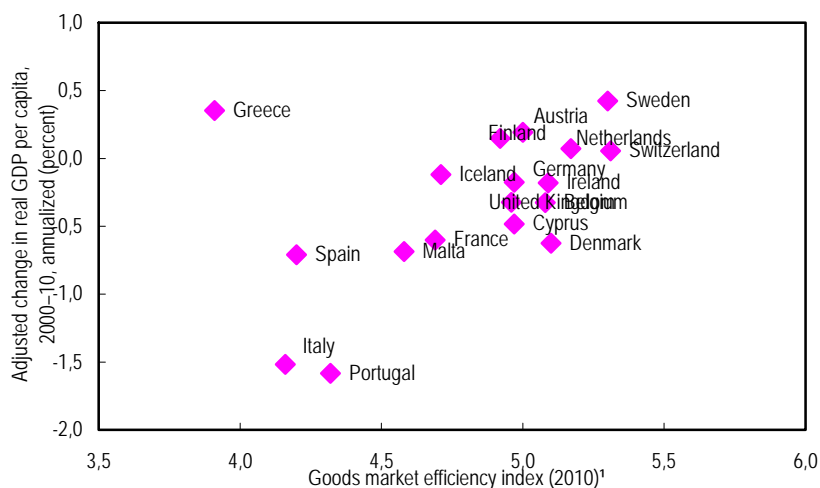
Source: Shadow Economies all over the World: New Estimates for 162 Countries from 1999 to 2007 (2010); Paper for World Bank Regional Report.

2. **Growth and competitiveness**

A number of priority areas to reduce the productivity gap, enhance trade and reap the benefits of the Single Market have been identified by the Commission in the Annual Growth Survey and by Member States. Reforms which improve the business environment and raise competitiveness are a priority. Member States need to focus on:

- **Further opening of sheltered sectors by removing unjustified restrictions on professional services and the retail sector.** Efforts are underway, notably in countries such as Italy, Portugal or Greece.
- **Ensuring a more effective government sector,** for example by ensuring that exchanges between administrations and enterprises as well as citizens can be done mostly digitally; reducing administrative burdens; increasing the absorption rates of EU funds, and ensuring that the judiciary operates swiftly and fairly. The Nordic countries are indeed world leaders in government effectiveness, and large gaps separate them from many other Member States. Worth noting also that the relative ranking of a number of Member States has

Product Market Efficiency and Growth, 2000–10

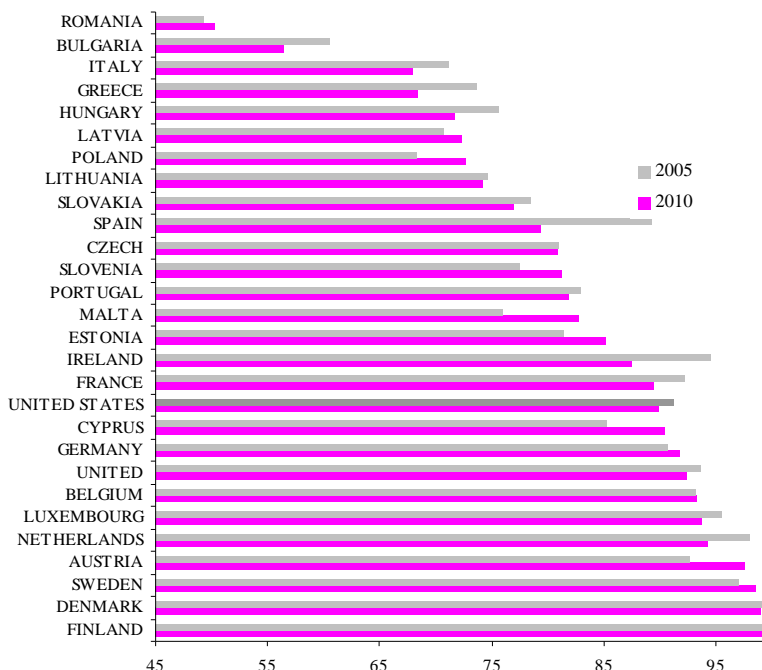


Source: IMF; October 2011 Regional Economic Outlook

* Higher value means better score. Because of data limitations, not all MS are shown.

The indicator 'Goods market efficiency' is developed by the World Economic Forum. It is an aggregate measure of domestic and foreign competition in product markets, including measures on the extent of market dominance, effectiveness of antimonopoly policy, tariffs, restrictive rules on FDI etc.

Global Government Effectiveness Rank

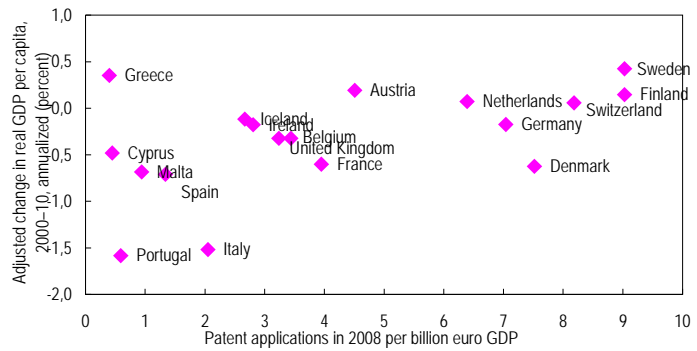


Source: World Bank Governance Indicators 2011, A x percentile rank implies that x percent of 213 countries in the world have a lower ranking on the indicator in that year. The WGI summarize information from 30 existing data sources on views and experiences of citizens, entrepreneurs, and experts in the public, private and NGO sectors. Government effectiveness captures perceptions of the quality of public services and the civil service; the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies.

deteriorated over the past few years.

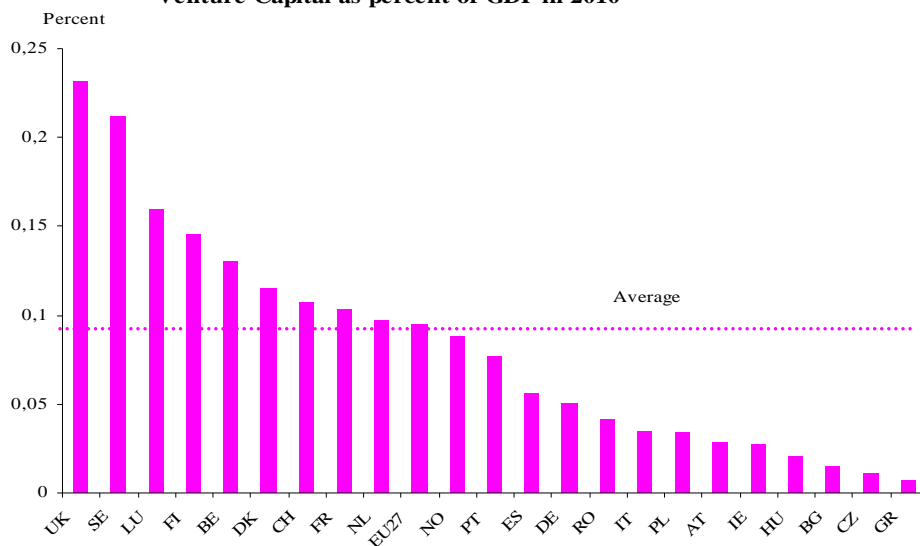
- Promoting innovation and business creation** by improving the quality of support systems, and promoting entrepreneurial skills. European venture capital markets remain underdeveloped, and patenting especially sluggish in some parts of Europe.

Patents and Growth, 2000–10



Sources: IMF October 2011 Regional Economic Outlook and 2011 Innovation scoreboard

Venture Capital as percent of GDP in 2010



Source: Innometrics. Innovation Union Scoreboard 2011

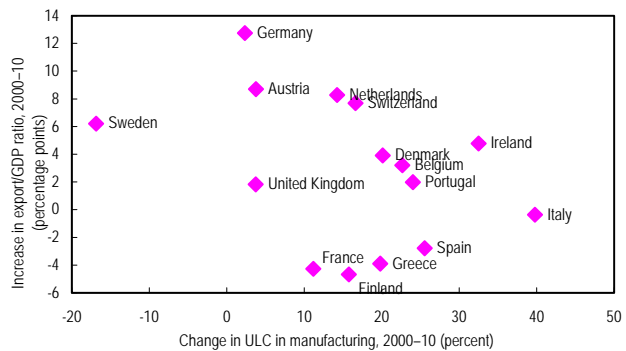
3. **Employment**

- Mobilising labour for growth:**

To create jobs and ensure a job-rich recovery, several priorities have been identified in the Annual Growth Survey.

- **Revising wage-setting mechanisms**, in conformity with national social dialogue practices, to better align changes in wages with

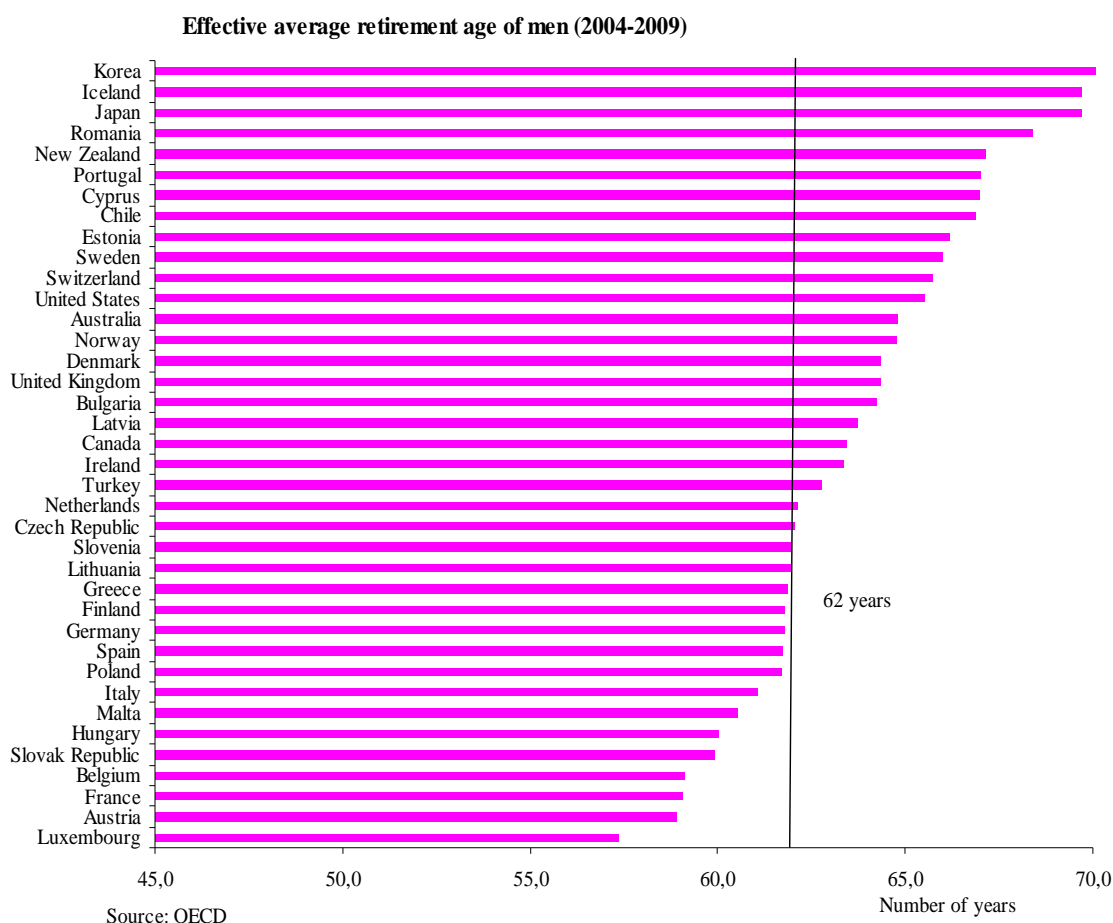
Labour costs and export growth (2000-2010)



Sources: IMF October 2011 Regional Economic Outlook

productivity developments. Recent substantial improvements notwithstanding, Belgium, Italy, Ireland, Spain and Portugal have seen nominal unit labor costs in manufacturing rising by over 20 percent in 2000-2010.

- Enhancing **labour mobility**. According to the September 2011 Eurobarometer, around one in 10 EU citizens has worked in another Member State, the proportion being higher in Luxembourg (35 percent) and Ireland (21 percent). But for more than half of respondents working abroad was considered of no interest.
- Restricting access to early **retirement schemes** and other early exit pathways while supporting longer working lives. In most EU member states, the average effective retirement age still remains below 62 years, while in many other developed parts of the world it now exceeds 65 years.

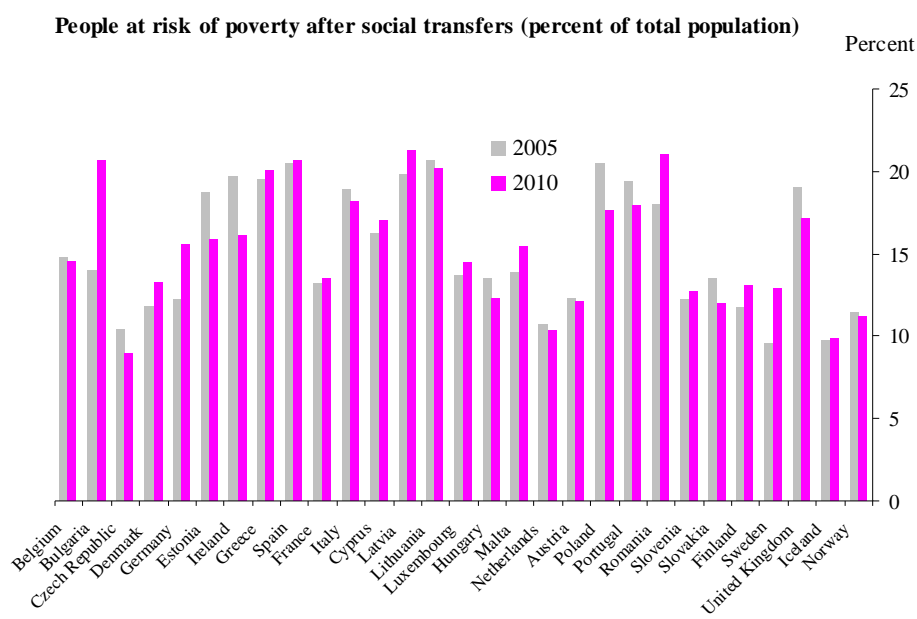


- **As agreed by the EC on January 30th, a particular effort needs to be placed on raising employment of the young.** Improving skill-sets, training and apprenticeships can play a role here.

▪ **Protecting the vulnerable:**

As demonstrated by the chart, many EU Member States face significant challenges with regard to poverty and social exclusion. Action should thus focus on:

- the effectiveness of social protection systems;
- the implementation of active inclusion strategies;
- access to services supporting integration in the labour market and in society.



This paper illustrates the extent of current reform challenges at hand. To address these, a comprehensive and broad approach, to be reflected in the national reform programmes, should be adopted, facilitating the reform process - politically, socially and via improved market perception. This and coherence across sectors and ministries would also ensure that reform efforts are sustained and can bear fruits relatively quickly.