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GO FOR GROWTH

AN AGENDA FOR THE EU IN 2010-2014

Combining fiscal sustainability and growth: a European action plan

March 2010

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KEY MESSAGES AND RECOMMENDATIONS

1. FISCAL SUSTAINABILITY: KEY INGREDIENT FOR THE RECOVERY
2. TACKLING THE CHALLENGE: WHAT IS AT STAKE FOR THE EU?
3. A COHERENT EUROPEAN STRATEGY BASED ON DISCIPLINE, REFORMS AND INVESTMENTS

1. Fiscal sustainability: key ingredient for the recovery

Rising deficits stabilised economies in crisis

Since the onset of the global financial crisis, sharp increases in public expenditure across the developed world and in Europe in particular have played a stabilising role, avoiding more serious short-term damage to the economy in terms of employment and output losses.

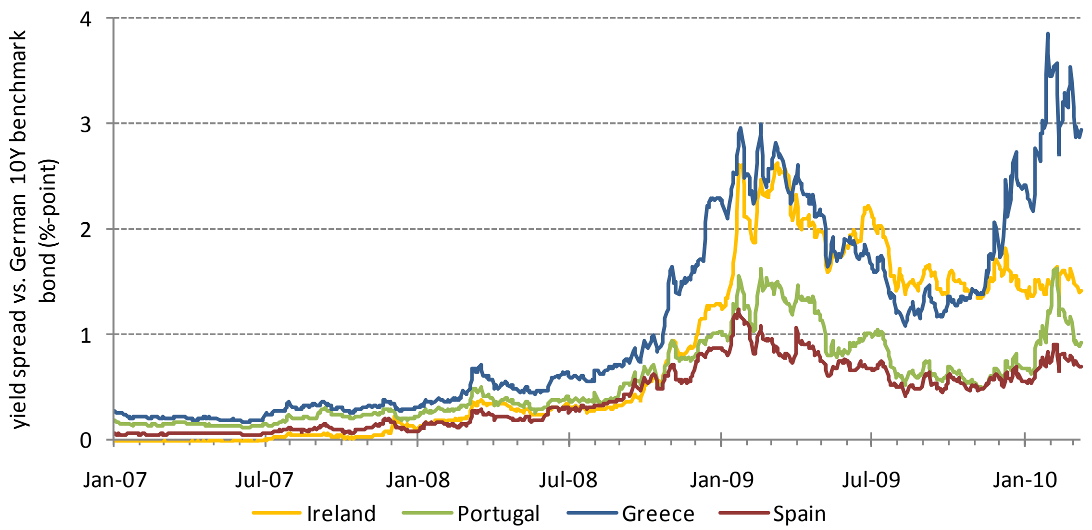
But now threaten the recovery

But the severe and synchronised deterioration in public finances now represents a major stumbling block to the recovery. Furthermore, large contingent liabilities from financial sector rescue measures are adding up to the already looming cost of demographic ageing.

Financial markets have reacted sharply …

This is of immediate concern and should be addressed with urgent and forceful reforms, as spelled out in this report. Massive refinancing needs of governments combined with growing mistrust in their capacity to face their future debt obligations is putting a severe strain on capital markets and the wider economy.

Chart 1 Tensions on sovereign bond markets

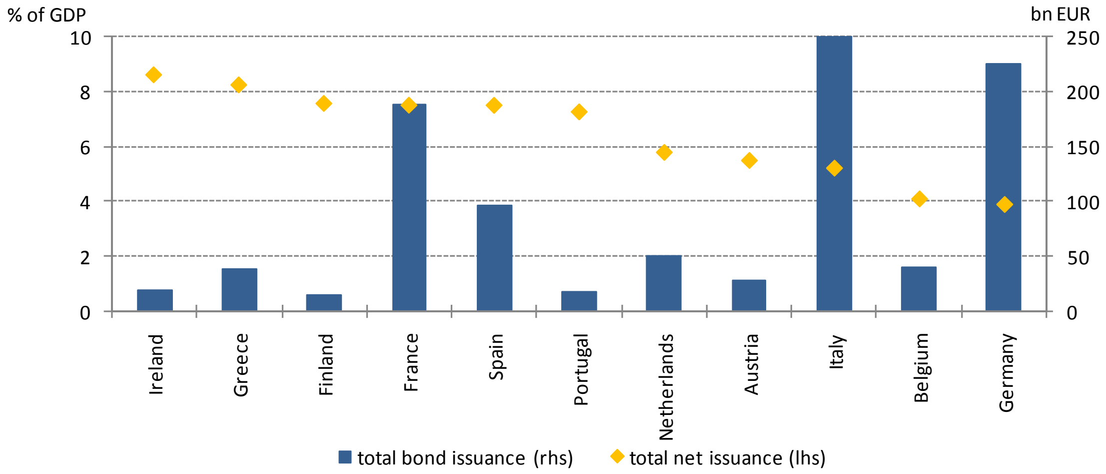


Source: BUSINESSEUROPE based on Datastream

... with negative effects for companies and the euro

These tensions are already crowding out companies' access to finance and investment plans across the EU, are eroding confidence in the European single currency and increasing the risk of renewed financial instability.

Chart 2 *Expected debt issuance in 2010*



Source: BUSINESSEUROPE based on Bank of America

2. TACKLING THE CHALLENGE: WHAT IS AT STAKE FOR THE EU?

Sustainability of public finances is a joint concern

The severity of the situation varies across countries, depending on the level of public debt and structural deficits, differences in the financing gap of social protection systems and the potential growth of individual economies, but sustainability is a challenge everywhere and is a common concern for EU Member States.

Euro-area governance is at stake

A common strategy is only taking shape gradually, which includes in the short term a commitment to take necessary action to prevent the risk of sovereign default within the EU. In the context of the European Monetary Union, this sets a precedent and will have consequences for its future governance. It explicitly recognises the need for greater and broader surveillance of national economic policies between countries sharing the single currency, as a necessary condition for growth and stability.

A comprehensive strategy must be defined urgently

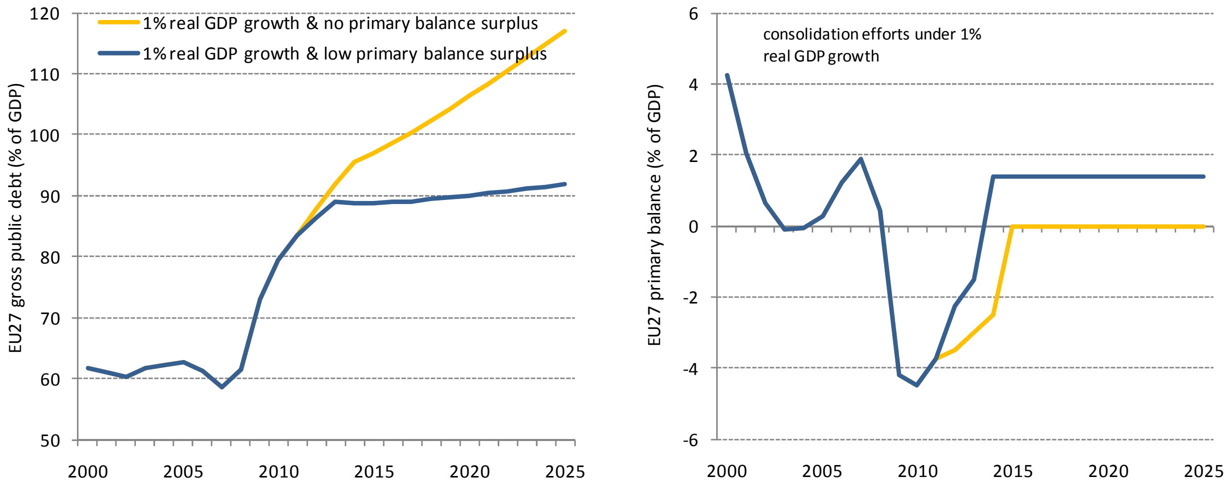
It is now time to flesh out more explicitly the parameters of this common exit strategy and give it a sense of heightened urgency. The cost of inaction would simply be unviable, both for individual Member States and for the European Union as a whole.

Public debt: the cost of inaction

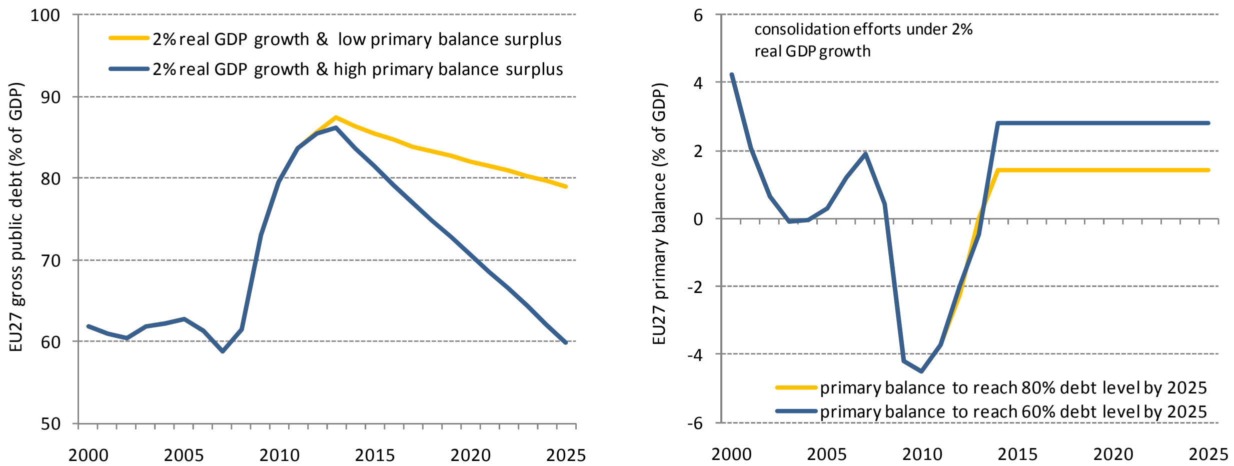
We estimate that if EU growth remains stuck at 1% and governments only aim to bring their primary balance (net borrowing excluding interest payments) back to equilibrium with a consolidation effort averaging 1% of GDP per year from 2011 to 2014, public debt in the EU would still continue to rise and reach 100% of GDP in 2017.

***Chart 3** Public debt scenarios*

a) weak GDP growth (1%), insufficient consolidation efforts



b) sustained GDP growth (2%), sufficient consolidation efforts



Source: BUSINESSEUROPE based on European Commission (AMECO) and calculations of Federation of Austrian Industries (IV)

Interest payments could outweigh research and education budgets

By that time, interest payments on public debt in the EU alone will outweigh the combined national budgets on education and research. This would represent a major dislocation of productive resources and greatly constrain public policies.

The clear objective of fiscal consolidation should be to regain scope for action and mobilise resources where it matters most for future wealth and job creation.

3. A COHERENT EUROPEAN STRATEGY BASED ON DISCIPLINE, REFORMS AND INVESTMENTS

"Exit" must go hand in hand with an "entry" strategy

It should be the primary task of the new European growth strategy - the so-called EU2020 agenda – to ensure a synchronised effort to support fiscal sustainability, growth and job creation at the same time.

This means combining an exit strategy to cap public indebtedness with an entry strategy, investing in skills, technology, modern infrastructures and business development.

60% debt ceiling: only reachable with serious consolidation and structural reforms

Some figures illustrate the task ahead. To bring public debt in the EU back to the Maastricht limit of 60% of GDP by 2025, we calculate that governments will have to maintain a structural surplus in their primary balance at a level of 2.8% of GDP from 2014 onwards and in parallel undertake reforms to increase the EU's growth potential back to 2%.

The European Council should play a leading role in defining an ambitious and comprehensive strategy to deliver on these objectives.

SGP remains the right framework to restore fiscal discipline

The Stability and Growth Pact remains the appropriate framework to ensure a coordinated return to fiscal discipline in the EU. It will play a key role in supporting credible commitments to bring deficits below the 3% of GDP limit in all EU countries by 2015 at the latest and then ensure that governments target sufficiently large primary surpluses to reduce public debt as a percentage of GDP.

Commission must be vigilant and exert its right of alert

This will require robust monitoring by the Commission based on correct reporting, adequate quality and reliability of public finance statistics.

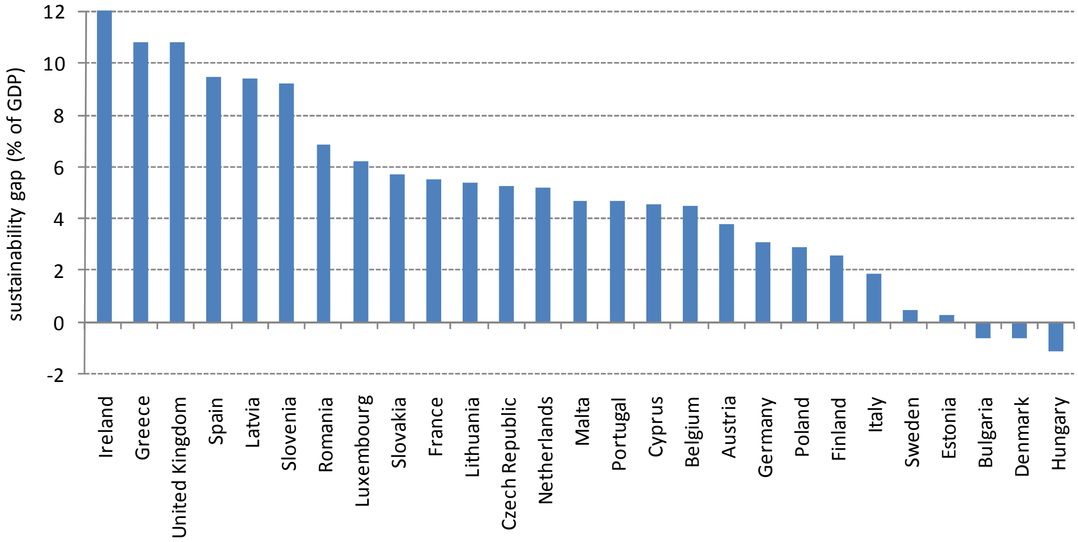
Eurogroup must strengthen economic governance

The eurogroup will also have to assume greater responsibility in improving economic governance in the euro area, and put greater emphasis on domestic and competitiveness imbalances, which have proved in most recent developments to be a major source of fiscal instability.

Consolidation should rest on reassigning expenditure priorities.

When consolidation strategies are being defined, the nature of selected measures will be absolutely critical. A reduction in net borrowing by the government must above all be achieved through a reassignment of policy priorities, expenditure cuts and efficiency measures in the public sector.

Chart 4 *Fiscal sustainability gap*

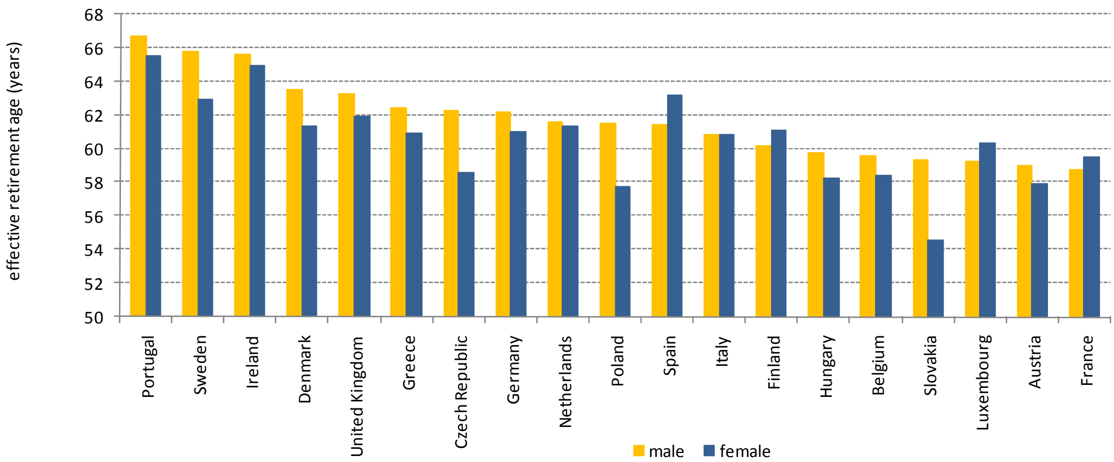


Source: BUSINESSEUROPE based on European Commission "Sustainability Report 2009"

Age-related costs call for social security, pension and labour market reforms

The projected impact of ageing should not be ignored. It is anticipated to outweigh the impact of the crisis in most Member States. Ensuring a full pre-funding of ageing-related cost would require unrealistically large primary surpluses, although sustainability gaps vary widely across countries. Reforms to social protection systems and higher employment rates of older workers are therefore a key factor for sustainability in an ageing society.

Chart 5 *Effective retirement age in the EU (average 2002-2007)*



Source: BUSINESSEUROPE based on OECD

Investment in education, innovation and infrastructure is a priority

These reforms should be combined with renewed commitments to achieve excellence in education, training and research systems and allow for the effective deployment of new technologies and modern infrastructures.

MAIN RECOMMENDATIONS

1. **Exit strategy: credible targets, expenditure cuts and social system reforms**

2. **Entry strategy: growth-enhancing investment and tax reforms**

3. **Growing our way out of the crisis: complementary reforms of product, labour and capital markets**

1. Exit strategy: credible targets, expenditures cuts and social system reforms

⇨ ***Tighter fiscal rules and better institutions***

The credibility of budget targets and controls at both EU and national levels is vital for government to regain trust and room to manoeuvre. We advocate binding fiscal rules to ensure long-run budgetary discipline and more reliable assessments of fiscal positions, taking due consideration of domestic imbalances and external competitiveness.

⇨ ***Greater efficiency of public administrations and credible cost-cutting measures***

A performance-oriented review of public services and spending structures is a key priority. Such a review should be carried out by an independent body and lead to recommendations for spending cuts and public sector reforms. Recourse to the market by the public sector should be generalised whenever a competitive market exists for services provided to citizens or for ancillary activities to state administration.

⇨ ***Increased scope for public-private partnership***

A greater role for the private sector in the supply of public services and infrastructure can help leverage expertise and financial means. It can also help stimulate innovation in the adaptation of services and infrastructure to climate change and environmental constraints. A minimum requirement would be to ensure equal treatment of public and private operators at community and national levels, including in the areas of access to public funding and of value added taxation.

⇨ ***Reforms of pension systems***

A closer link between retirement age and life expectancy is needed. This should go hand in hand with financial benefits for longer working lives and the phasing-out of early retirement schemes. Keeping up employability by additional training and re-training throughout working life, promoting flexicurity and allowing part-time old-age retirement are effective tools in this respect. Such reforms and the promotion of effective and reliable occupational/private pension schemes (second and third pillar) will help reduce a disproportionate savings glut and support domestic demand in countries facing severe demographic challenges.

⇨ ***Improve the efficiency of the healthcare sector***

Reforms need to address a series of complex aspects, including the promotion of efficiency benchmarks in terms of staff and in-patient facilities and degrees of competition among providers of care and health insurance companies. The adjustment of statutory health insurances' list of goods and services provided and an assessment of resources are allocated between preventive and curative treatments should help to define the right balance of financing between patients, public and private insurers.

2. Entry strategy: growth-enhancing investment and tax reforms

⇨ ***Higher return on education and training***

A better match between qualifications and the needs of companies is a vital measure to tackle labour market and public finance challenges in an ageing society. This will be key to avoid a lost generation paying a disproportionate cost for the crisis. Education and training systems must prepare young people for their first job by providing them with the skills companies demand; this implies better anticipation of future skills as well as well-functioning labour markets based on flexicurity principles. The practice of vocational training should be extended to address in particular the issue of youth unemployment. Lifelong learning must also become a reality so that workers constantly improve their competencies and the unemployed can improve their skills and employability.

⇨ ***More and better targeted efforts in R&D and innovation***

Public programmes must seek to leverage investment in R&D and innovation and be coordinated within a consistent EU wide strategy. Greater interaction between business and universities, the development of risk-sharing facilities and venture capital markets would be important contribution to boosting growth and innovation. In the transition to a low-carbon economy, it is important to encourage systemic innovation and to orient public procurement towards achievement of global outputs in terms of service quality and environmental impact.

⇨ ***Need to prioritise infrastructure investments***

To promote projects linked to innovation and growth in the fields of information and communication technologies, mobility, energy efficiency and renewable energies. Financing those investments will require public funding as a lever to private finance, and developing a true market for infrastructure financing.

⇨ ***Growth-enhancing tax reforms***

To complement spending reforms and tighter budget controls, tax systems should become more supportive to growth and job creation. Tax and benefit systems must create greater incentives to participate in the labour market and make work pay. Simplifying tax systems, reducing compliance costs and removing double taxation in the field of direct and indirect taxation would make more investment and trade economically viable and contribute to greater benefits of the internal market, in particular for SMEs.

3. Growing our way out of the crisis: complementary reforms of product, labour and capital markets

Consolidation policies must rest on a broader growth strategy ...

These priorities must be an integral part of a broader strategy seeking to remove structural impediments to growth and allow for better functioning product, labour and capital markets. This is the best way to rebuild tax bases and put public debt on a sustainable path.

... building on a revitalisation of the internal market...

This should be done at EU level by reinvigorating the internal market, developing an integrated EU industrial policy and supporting access to international markets. Completing the single market and increasing competition in most regulated sectors will be particularly important to unleash a significant growth potential and help to realise efficiency gains for European companies, in particular SMEs.

... far-reaching reforms addressing national bottlenecks...

At national level, structural reforms must be fostered in priority areas, developing a true benchmarking culture between Member States. Labour market reforms will be essential to ensure the sustainability of social systems and provide real opportunities for successful transitions between jobs and for overall employability. Flexicurity is the right approach to raise employment rates across Europe and will contribute to the sustainability of both labour markets and public finances.

With its Reform Barometer published in March 2010, BUSINESSEUROPE demonstrates its strong commitment to tackling structural impediments to growth at the national level, emphasising its importance for the overall success of the EU.

...and greater financial stability.

Fiscal sustainability is also tightly interconnected with the health of financial markets, their capacity to deliver sufficient financing to the economy and the rules and institutions that will govern them in the future.

Beyond the planned exit strategies from state guarantees offered to the financial sector, measure supporting access to finance and greater stability in the international financial system will be key factors to restore healthier public finances and better protect tax payer money in the future. This should be achieved through a well balanced financial reform agenda seeking to improve prudential rules, to identify systemic risks in due time and to allow for a greater role of privately funded solutions to deal with financial market failures.

DETAILED ANALYSIS AND RECOMMENDATIONS

1. Exit strategy: credible targets, expenditure cuts and social system reforms

2. Entry strategies: investment in research, skills, infrastructure and growth enhancing tax reforms

3. Financial stability, crisis management and public finances

1. Exit strategy: credible targets, expenditure cuts and social system reforms

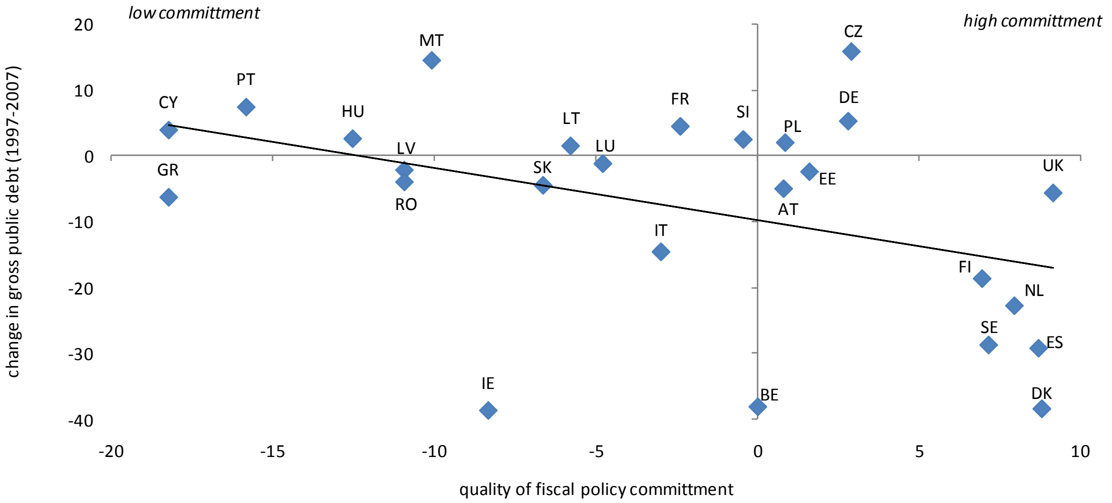
The credibility of budget targets and controls at both EU and national levels is vital for government to regain trust and scope for action. We recommend a mix of binding fiscal rules and strictly observed non-binding frameworks to ensure long-run budgetary discipline and more reliable assessments of fiscal positions.

1.1 Coordination at EU level and effective institutional monitoring

The Stability and Growth Pact (SGP) remains the appropriate instrument to coordinate and monitor the return to fiscal discipline across EU member states.

- Fiscal consolidation strategies should be planned in 2010 and be ready for coordinated implementation in 2011. In all EU Member States, excess deficits should be corrected at the latest by 2015.
- Further ahead, the Stability and Growth Pact will need to ensure and governments target sufficient large primary surpluses to bring debt to GDP ratio below 60% by 2025 at the latest.
- Differentiation in national adjustment paths will have to reflect initial fiscal positions, future contingent liabilities and the growth potential of individual economies. The rationale for the deadline to correct excessive deficits and to define medium-term budgetary objectives must be strengthened and must better integrate reform efforts. This requires an adequate framework to measure the impact of product, labour and social security reforms on the sustainability of public finances. The focus on debt sustainability should be increased.
- More consistent assessments of fiscal positions are also needed, improving the quality and reliability of statistics, relying on prudent assumptions, taking greater consideration of domestic imbalances and the external competitiveness of individual economies.
- Increased efforts to enhance the independence, integrity and accountability of the European statistical system, in particular at the level of the national statistical institutes and national sources that are not considered as statistics producers, should aim to secure the correct reporting, adequate quality and reliability of the statistics that these assessments are based on.

Chart 6 *Clear fiscal policy commitments have positive effect on public debt reduction*



Sub-components of quality-indicator: fiscal rule index, medium-term budgetary framework index and transparency

Source: BUSINESSEUROPE based on European Commission

1.2 THE ROLE OF NATIONAL RULES AND INSTITUTIONS

In addition to close monitoring at the European level, tight fiscal rules must be set at the national and all sub-national levels to pre-empt government policies that shift the burden of consolidation to future generations.

- An independent review group could be given a remit to identify immediate expenditure reductions by at least 10% of current spending. Further medium-term targets should be set in consideration of the potential benefits to be derived from market testing of certain government activities.
- A similarly independent fiscal policy council would ensure compliance and informed national debate on expenditure reductions. Particular focus should be placed on long-term sustainability.
- National fiscal rules must be explicit in terms of their goals, self-consistent and quantifiable. They should be linked to each other and be consistent with the Stability and Growth Pact rules.
    - *Ceiling on the budget deficit, on the debt level, and on expenditures are all valid options, to be decided by national governments.*
    - *The budget process needs to be reformed to place the consolidation process in a medium-term framework.*
    - *Budget attributions should follow a top-down approach in which the ministry of finance or the prime minister negotiates budget allocations with spending ministries.*
- Fiscal rules should nevertheless provide sufficient built-in flexibility to respond to shocks and foresee institutional mechanisms to translate deviations from the targets into incentives to take corrective action.
- Deficit rules should be based on the structural balance in order to avoid pro-cyclical effects, and expenditure rules should be linked to the revenue side, and vice versa.
- The enforcement mechanism is crucial for the effectiveness of fiscal rules. Sanctions should be automatic, costly in terms of sub-national administration autonomy (not financially), and guarantee a quick return to compliance.

***Table 1** Examples of non-binding fiscal rules in Europe*

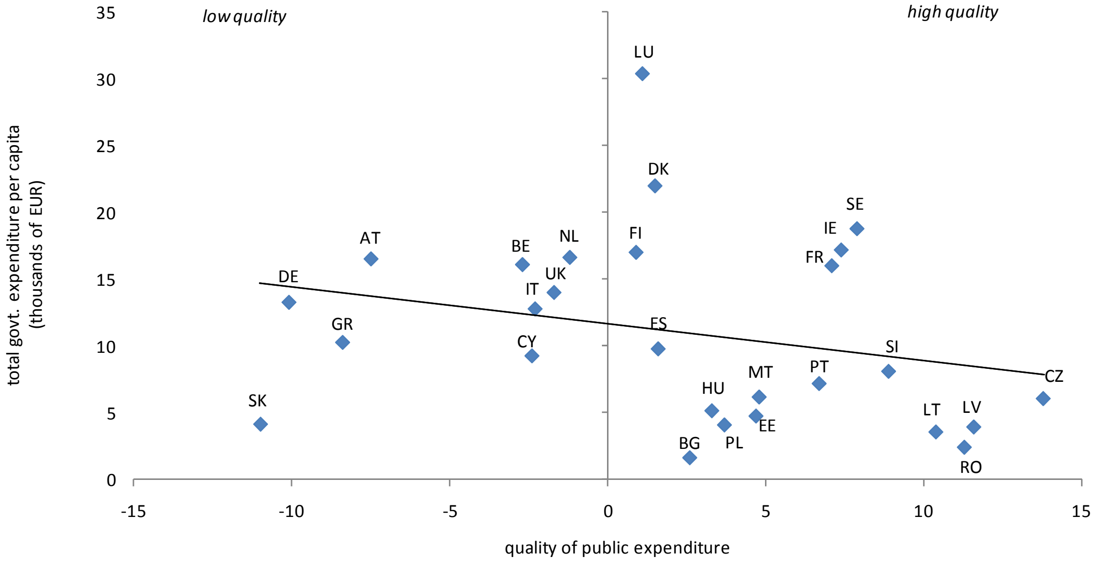
<table>
<tr><th rowspan="2">Country</th><th rowspan="2">Introduction of rule</th><th colspan="2">Debt levels, % of GDP</th><th rowspan="2">Measures / Targets</th></tr>
<tr><th>year prior to rule</th><th>2007</th></tr>
<tr><td>Netherlands</td><td>1994</td><td>96.8</td><td>52.1</td><td>ceilings for aggregate and sector-specific expenditures</td></tr>
<tr><td rowspan="2">Finland</td><td rowspan="2">1999</td><td rowspan="2">60.9</td><td rowspan="2">41.5</td><td>structural surplus of 1% of pot. GDP</td></tr>
<tr><td>central government deficit < 2.5% of GDP</td></tr>
<tr><td rowspan="2">Sweden</td><td rowspan="2">2000</td><td rowspan="2">73.7</td><td rowspan="2">47.9</td><td>surplus for general government, retirement system, local government</td></tr>
<tr><td>average annual net lending of 2% of GDP over business cycle</td></tr>
</table>

Source: BUSINESSEUROPE based on calculations of Federation of Austrian Industries (IV)

1.3 INCREASE EFFICIENCY OF PUBLIC SECTOR AND CREDIBLE COST-CUTTING MEASURES

Fiscal consolidation represents a potential platform for a renewed focus on public sector efficiency, i.e. allocation efficiency and productive efficiency.

***Chart 7** Quality of public expenditure does not necessarily depend on amounts spent*



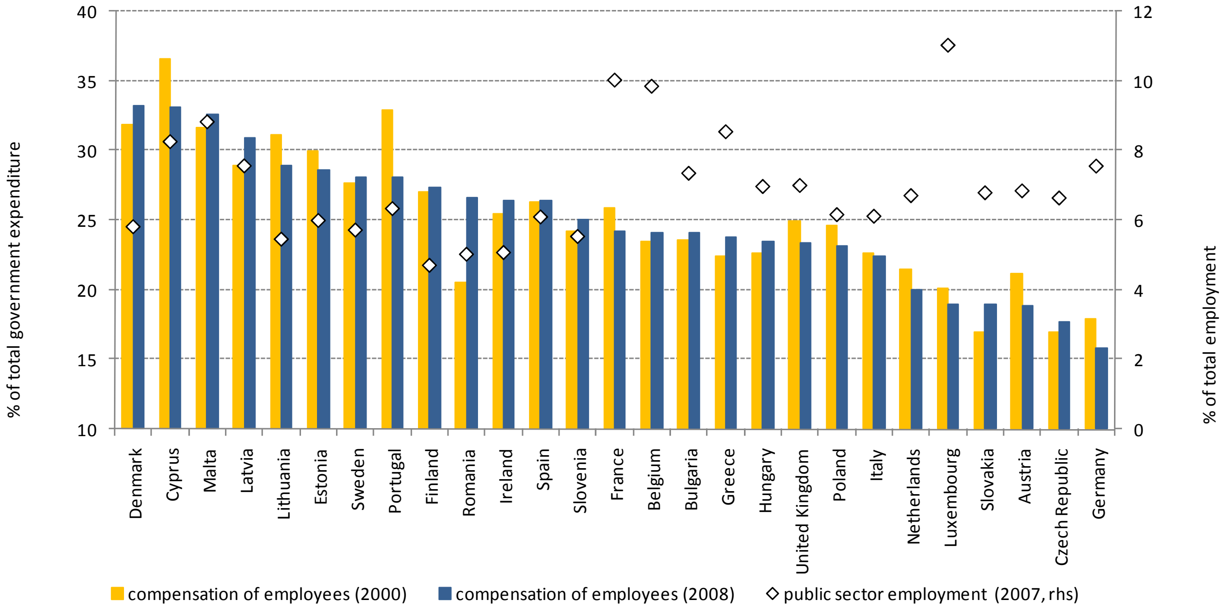
Sub-components of quality-indicator: general government gross fixed capital formation, productive spending (transportation, R&D, education, health)

Source: BUSINESSEUROPE based on European Commission and Eurostat

- Introduction of performance elements which focus on outputs/outcomes instead of appropriations and are assessed with good, relevant and timely information to highlight which programmes are achieving their objectives and help identify policies and processes that work.
- Reduction of administrative burden inside the government by reassessing processes on a 'fit for purpose' basis.
- Increase transparency and foster accountability within the government and public administration
- Analyse trends in numbers of civil servants and set containment targets where adequate.
- Development of adequate human resources management based on performance assessment and performance pay
- Realigning the size of decentralised administrations to exploit potential economies of scale.

  Relevant reductions of local public expenditure and decentralised public bodies could be obtained locating potential economies of scale. Current constituency boundaries should be reviewed realigning the size to the optimal level.
- Fiscal federalism can only be effective if rationalised by the size of externalities produced by sub-national governments and based on strict fiscal rules.
- Widening the use of e-procurement. In addition to cost savings, e-procurement could achieve a wider choice of suppliers, lower cost, better quality and improved delivery.

Chart 8 *Expenditure on employees is one of the most relevant items in total government expenditure*



Source: BUSINESSEUROPE based on AMECO and Eurostat

- Benchmarking analysis
  - *within a member state, especially at regional and local level, could make it possible to compare public bodies' efficiency and lead to savings and allocation improvements.*
    Benchmarking exercises could be applied in particular to educational or healthcare outputs and, at the local level, to business rates with a view to improving attractiveness of local areas as a business location.
  - *at international level*
    National competitiveness councils (drawing members from academics, business federations, entrepreneurs, trade unions and consultants) could produce annual benchmarking reports, which apart from indicators on productivity, prices, pay costs etc, cover the business environment around taxation and regulation, physical infrastructure, transport and energy infrastructure, ICT education and R&D infrastructure. To ensure follow-up, reports should also provide advice to government based on the findings.

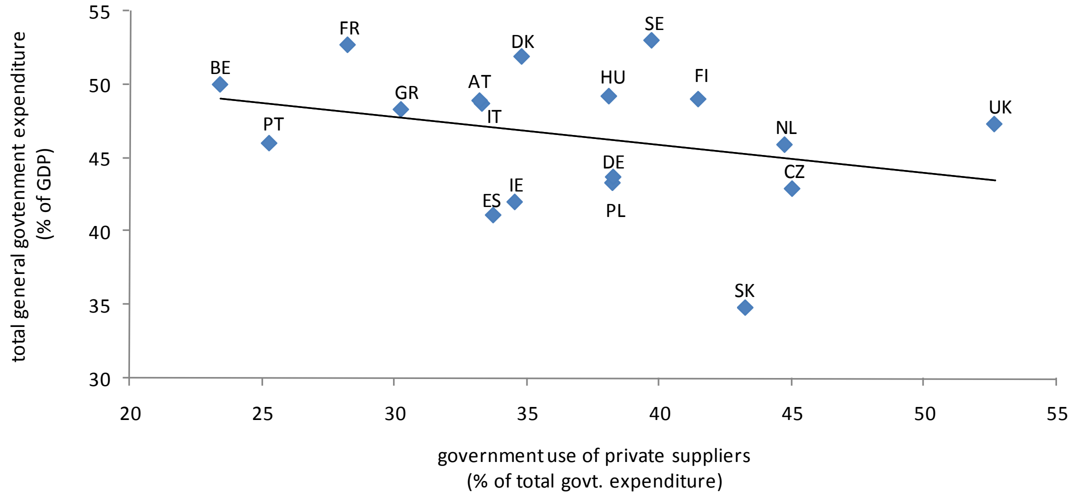
- Expand the use of outsourcing of ancillary services such as IT management, catering and estate management to areas of back office work on the basis of best value for money. Consider market testing the delivery of social benefits payments.

- Consider reducing net cost of public transport through combined policies to market test provision of quality service, to reduce cost and to raise revenues such as road tolls and congestion charging.

1.4 INCREASE THE ROLE OF PUBLIC-PRIVATE PARTNERSHIPS IN THE SUPPLY OF COST-EFFECTIVE PUBLIC SERVICES

Public expenditure in the EU represents on average 48% of GDP. Within that amount, significant sums are dedicated to the provision of public services to the population and to the construction of public infrastructure. Increased use of public private partnerships especially in waste, water, energy, transport and certain infrastructure provision could improve cost efficiency and reduce burdens on public budgets.

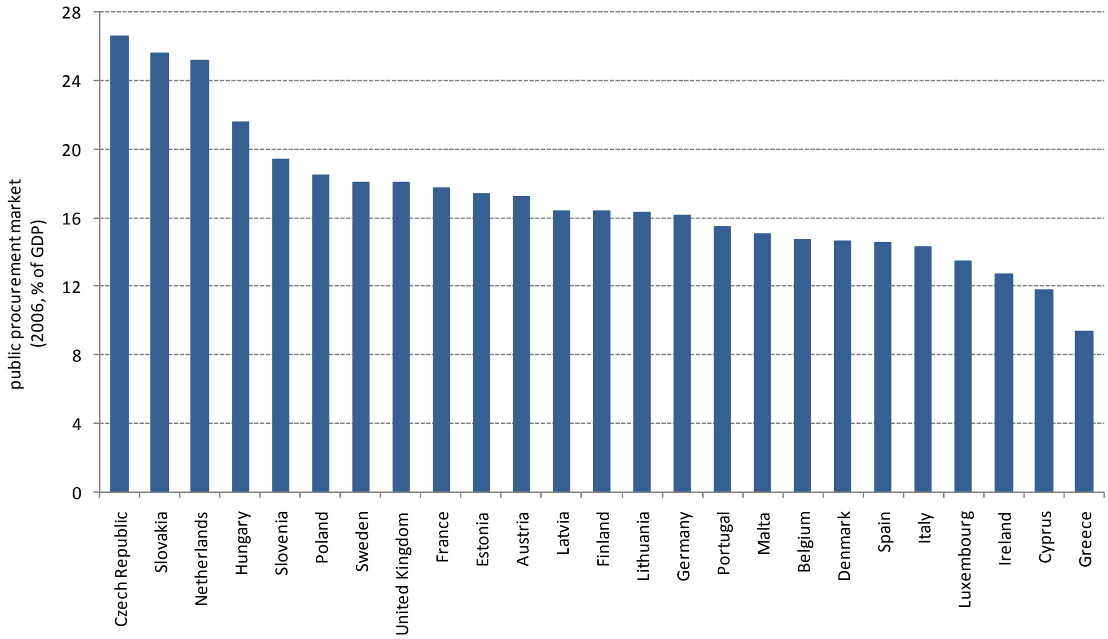
Chart 9 *Government expenditure and government use of private suppliers*



Source: BUSINESSEUROPE based on Federation of Danish Industry (2010 Global Benchmark Report 2010) and Eurostat

- Encourage local authorities to differentiate between their duties to ensure provision of public services at quality levels that they set, and the actual delivery of the services which can usually be market tested.
- Encourage the legal separation of the two tasks and promote proper contractual relationships between policy-maker and service provider (public or private) as has been initiated for transport.
- Encourage regions and local authorities to set development plans for public services that incorporate targets for service and environmental achievements, and monitor their effectiveness in reaching those goals.

Chart 10 *The size of public procurement markets*



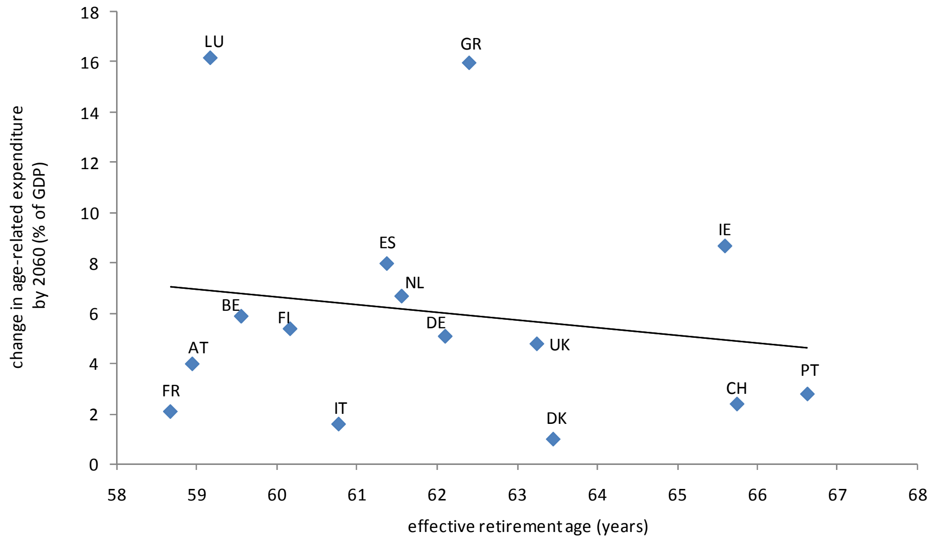
Source: BUSINESSEUROPE based on RPA Study

- Link structural and cohesion funding to projects in those sectors that demonstrate an integrated management approach consistent with such plans.
- Promote equality of treatment between public and private operation of public services, and in particular suppress de facto discrimination through VAT differentials.
- Promote equality of treatment of PPPs vis-à-vis traditional procurement processes in connection with access to Community funding, and in general as regards public subsidies.

1.5 Reform of Pension Systems

Efficiency measures and cuts in public expenditure will not suffice to restore long-term sustainability. Governments will need to speed up the reform of social security systems. Incentives to extend working lives and increase labour market participation of older workers will play a key role. Beyond savings to social security systems, an increase in statutory and effective retirement ages will contribute to supporting growth and domestic demand by raising income over the entire lifecycle.

Chart 11 *Effective pension age and change in age-related expenditure until 2060*

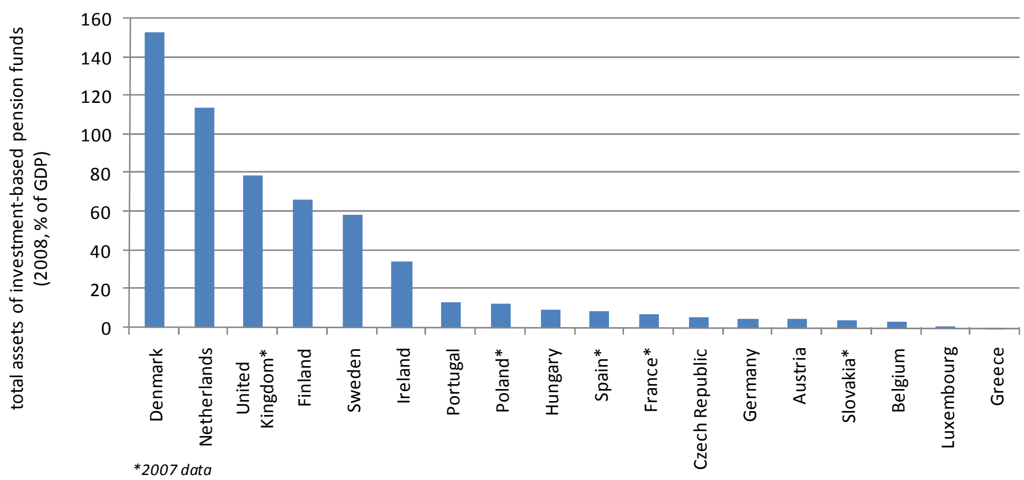


Source: BUSINESSEUROPE based on European Commission and OECD

Pension systems have been or are being reformed in some Member States but more and speedier efforts will be needed. Directions for (further) reforms are:

- Increase the retirement age, discourage early retirement arrangements
  Introducing a longevity coefficient which allows the retirement age to be adjusted to reflect changes in life expectancy is useful given that projections often fail. This should go hand in hand with the creation of financial benefits for longer working lives. It is also important to establish a clear link between pension benefits and contributions.
- Provide incentives to increase employment rates of older workers
  Increasing employment and extending working lives is necessary, both due to financial considerations and the expected tightening of the labour market in an ageing society. Efforts in career and workplace organisation can assist workers in extending their working life. Keeping up employability by additional training and re-training throughout the working life, promoting flexicurity and allowing part-time old-age retirement are effective tools in this respect.

Chart 12 *Assets of investment-based pension funds*



Source: BUSINESSEUROPE based on OECD

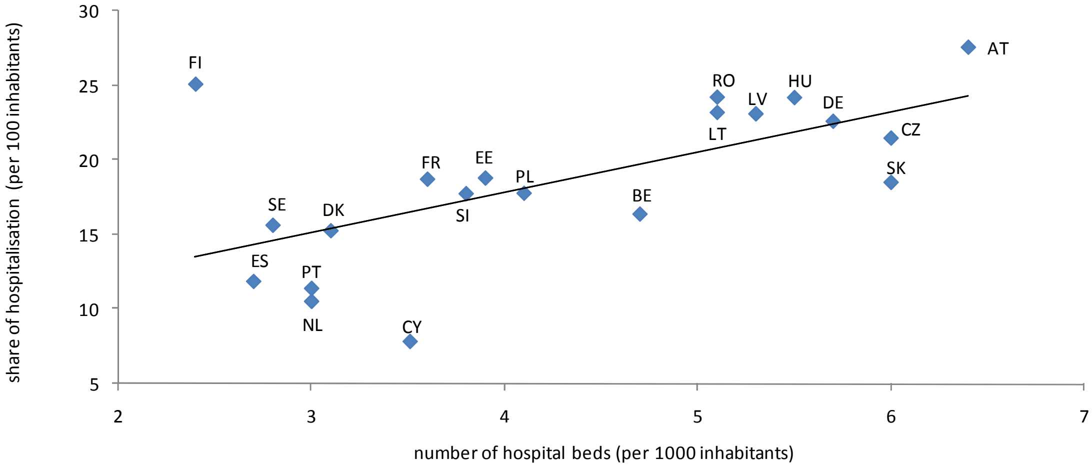
- Promote the use of occupational/private pension schemes
  In some countries, a large part of retirement income is provided by occupational/private pensions. Second-pillar pension schemes must therefore remain cost-effective, where possible taking full advantage of solidarity elements, but also reconsidering the target benefit levels (replacement ratios) and the sharing of risk between employers and employees. Funded scheme design may need to be reviewed to increase the ability to cope with risk in the investment and pay-out phases in the longer run.
  The further promotion of privately-funded schemes must go hand in hand with a balanced agenda for financial market reforms, increasing their stability and reducing systemic risks.

1.6 HEALTHCARE REFORMS

Ageing populations place a great burden on future healthcare budgets. Given the complex and hardly predictable mechanisms of progress in medical technology, which have accounted for a considerable share of expenditure growth, current projections may even underestimate the challenge at hand.

At the same time, effective healthcare systems could be to some degree self-financing as they may result in higher tax revenues by maintaining the health of the workforce, reducing sick days and helping people increase their productivity.

***Chart 13** Supply-led expenditures*



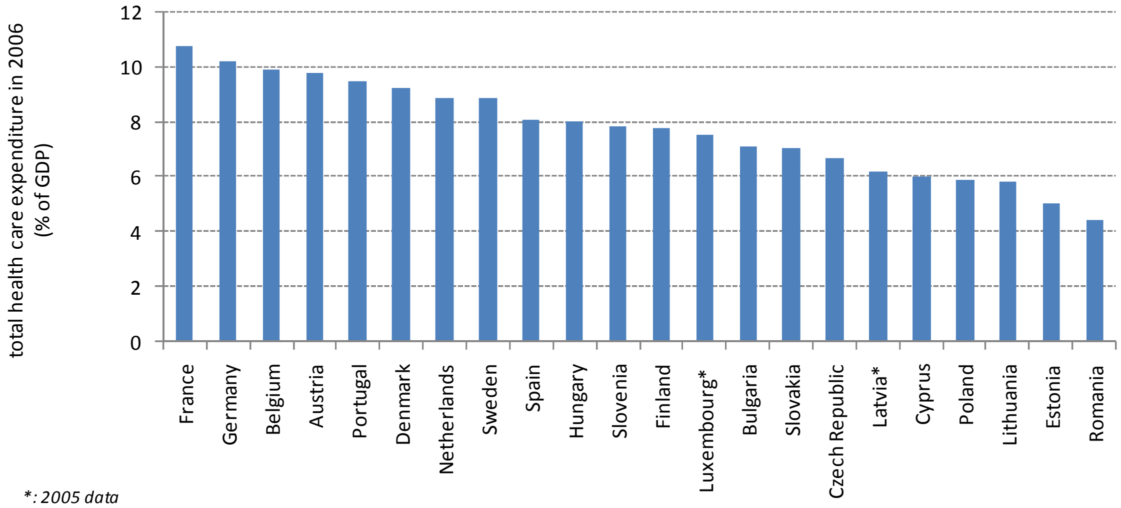
Source: BUSINESSEUROPE based on Eurostat and WHO/Europe (Health for all Database, August 2009)

Given its multidimensional nature, a reform of healthcare needs to consider several complex issues:

- Making public health care systems more effective and promoting efficiency benchmarks based on output measurement and capacity requirement in terms of staff and in-patient facilities;
- Adjusting statutory health insurances' list of goods and services provided without creating discriminatory rationing (e.g. no more hip operations for the elderly);
- Ensuring that appropriate resources are allocated between preventive and curative treatments, and that technology aiming at fostering efficiency and ensuring high-quality services are effectively assessed and managed while keeping costs to a minimum;

- Defining the right balance of financing between patients, public and private insurers;
- Increasing the degree of competition among providers of care and health insurance companies in order to make the system more efficient and innovative.
- Addressing overlapping or inefficient (regional) hospital infrastructure and the real demand for healthcare services.

Chart 14 *Large divergences in healthcare expenditure*



*: 2005 data

Source: BUSINESSEUROPE based on Eurostat

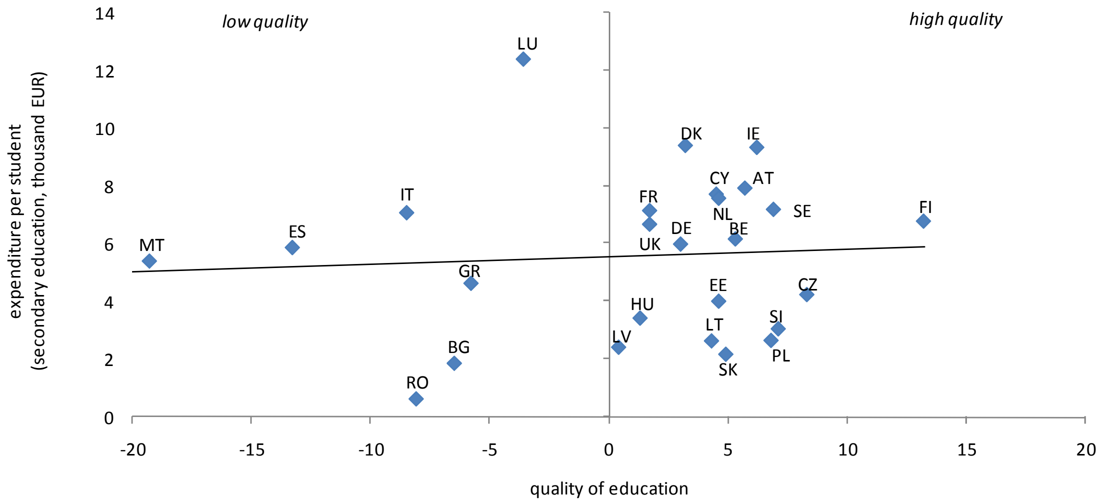
2. Entry strategies: investment in research, skills, infrastructure and growth enhancing tax reforms

Since the debt surge mostly reflects revenue losses there is an urgent need to implement reforms that foster strong and sustainable growth. Higher growth rates raise revenues and should consequently be a priority for governments. A clear objective of fiscal consolidation is to regain scope for investment in areas supporting wealth and job creation.

2.1 Skills, education and labour participation

Human capital is a key element for future economic and social growth. However, due to often overly rigid labour market regulations Europe risks a "lost generation" at a time when ageing and a shrinking labour force start to take their toll. Well-functioning labour markets are a condition for sustainable growth, higher participation rates and many job openings for young people. In order to stay competitive and generate growth companies need a qualified and adaptable workforce.

***Chart 15** Quality of education and expenditure per student are note clearly correlated*

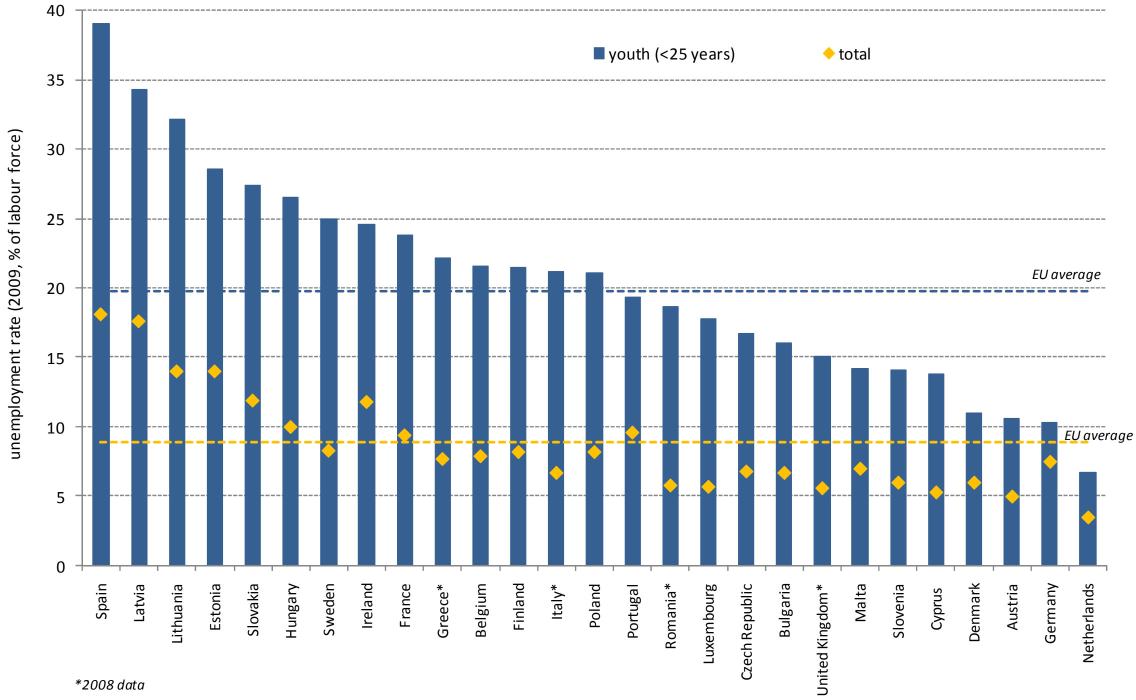


Sub-components of quality-indicator: total PISA score, educational attainment, youth educational attainment, early school leavers, quality of education system

Source: BUSINESSEUROPE based on European Commission and Eurostat

- Make education and training systems more efficient and modernise them so that they give young people the skills and competences that companies are looking for – the EU initiative "New skills for New Jobs" should be promoted.
- Make lifelong learning a reality so that the employed constantly improve their competences and the unemployed can adapt their skills in order to improve their employability and avoid drifting into long-term unemployment. Recourse to vocational training should also be increased.
- Modernise labour markets along the lines of flexicurity so that people can gain from moving to jobs where their particular skills and competencies are valued the most. The implementation of flexicurity principles should also go hand in hand with necessary reforms that make work pay and facilitate the return of unemployed into jobs. While a necessity to cope with the effects of demographic ageing, this will also represent a substantial financial relief for social security systems.

Chart 16 *Risking a "lost generation"*



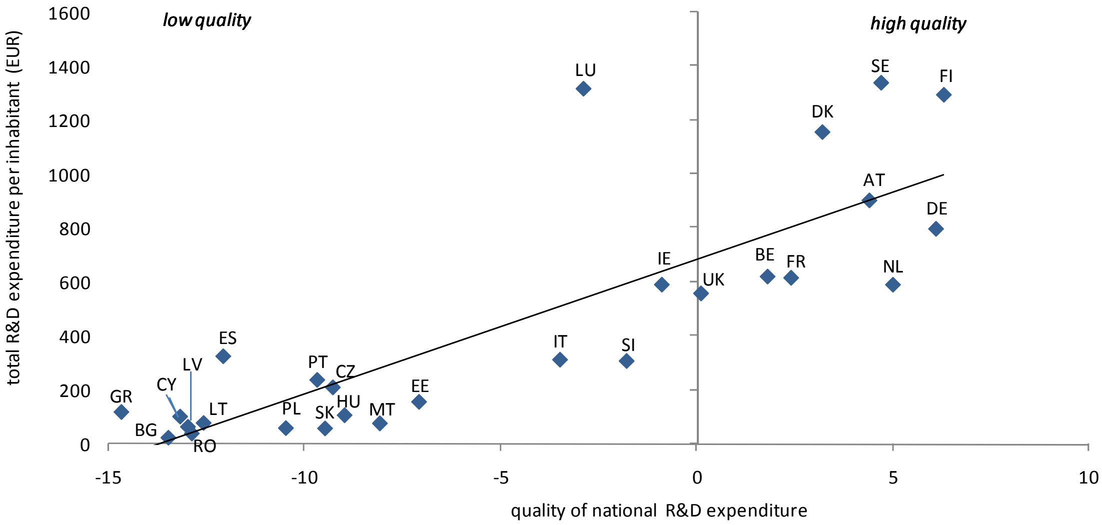
Source: BUSINESSEUROPE based on Eurostat

- Increase participation rates in particular for young people, women and the elderly by speeding up education and training reforms, active labour market policies, provision of better childcare facilities and more flexibility in working life.
- Promote a more performance and output-oriented schooling and training system across Europe
- Further develop a genuine benchmarking culture in Europe enabling the individual national education and training systems and institutions to benchmark themselves with the global top performers and make the improvement of education and training one of the priority targets in the Europe 2020 strategy.
- Implement transparent public funding schemes for the school system and reduce overly bureaucratic multiple responsibilities.

2.2 R&D AND INNOVATION PROGRAMMES

Reaching the target of 3% of GDP spent on R&D could increase EU GDP by between 2.6% and 4.4%. Positive spill-over effects will be substantial and the considerable boost in output would help put the sustainability of public finances on a firmer footing. Increasing the level of R&D and innovation public spending remains a strategic priority.

Chart 17 *R&D – increasing quality requires sufficient financing*

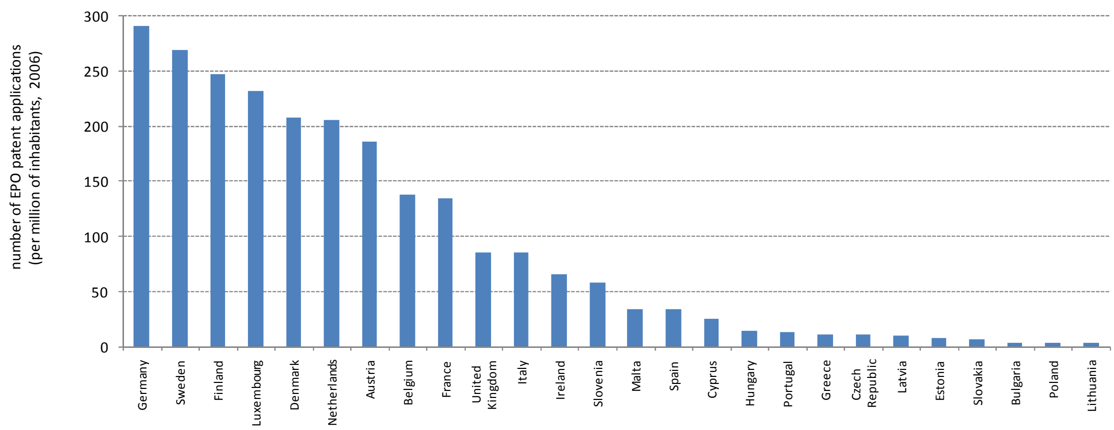


Sub-components of quality indicator: patents granted, number of patent applications, scientific publications, citations per scientific publication, technological readiness, innovation and basic research.

Source: BUSINESSEUROPE based on European Commission and Eurostat

- Enhancing the efficiency of public support policy is crucial in order to maximise the impact of every euro spent. This can be achieved through a better coordination between national R&D policies and programmes within the European Research Area (ERA). The EU Strategic Energy Technology Plan (SET-Plan), for example, is a promising tool for coordinating actions managed at both national and EU level.
  The efficiency of public support policy can also be improved by a strengthened connection of national R&D programmes to European societal challenges.
- Improving conditions for self-financing and strengthening access to specialised innovation finance
  It is important to develop tax incentives to support investments in R&D and innovation, in particular for young innovative companies. At the same time, the permanent risk-sharing products offered by the European Investment Bank (EIB) should be expanded.

Chart 18 *Large differences in patent applications*



Source: BUSINESSEUROPE based on Eurostat

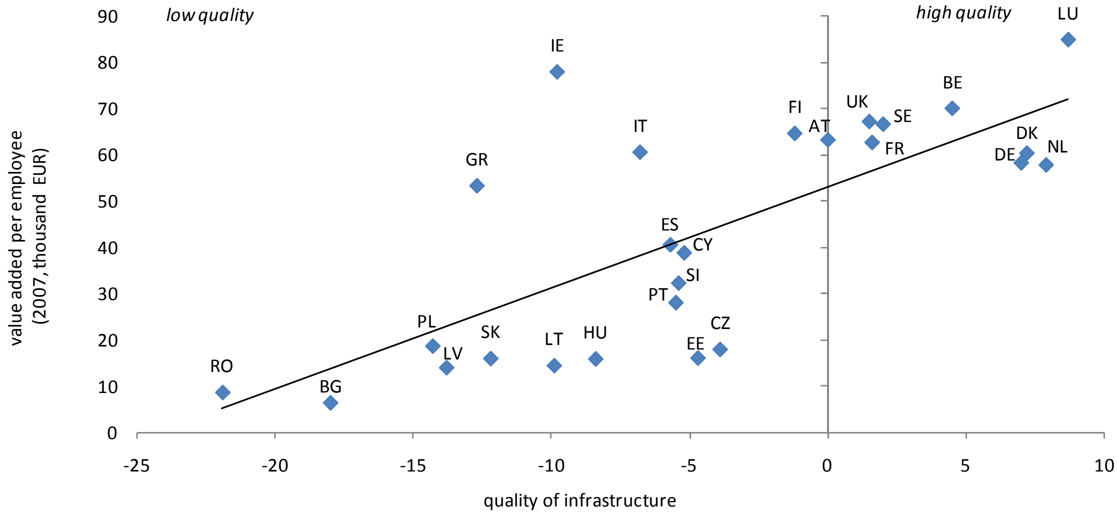
- Reducing costs of applying innovation / R&D results by stimulating market demand and removing administrative obstacles
  Developing demand-side instruments is key to boost innovation. The EU "Lead Market Initiative" is a good step in that direction as it aims to create better and more innovation-friendly market framework conditions (including regulation, procurement and standardisation). Progress in implementing this initiative should be accelerated.
- Developing breakthrough technologies and products leading to major global carbon emission reductions and to new businesses. This will need a significant increase of financial support to research and development, pilot and demonstration projects within the EU, flanked by a new industrial policy facilitating the move towards a low carbon economy. The EU climate strategy should be much more oriented towards accelerating development and deployment of new technologies.
- Reviewing EU budget priorities to be fully adapted to an innovation-based economy. We call for a reallocation of resources from agriculture and cohesion to research and innovation in the next Financial Perspectives (2014-2020).

2.3 INFRASTRUCTURE NEEDS AND FUTURE GROWTH AREAS

Over the next 10 to 15 years Europe will face substantial infrastructure investment needs - estimates are trillions of euros. Reasons include the development of information and communication networks, renewal and diversification of power generation capacity, the implementation of European standards in the environmental sector (water, waste), construction or renovation of motorways and railways, adaptation to and mitigation of climate change.

Facing tight budgetary constraints, governments will have to prioritise investments stemming from legal obligations and those that will boost innovation and growth (information and communication technologies, mobility, energy efficiency and renewables and other low-carbon energy sources).

***Chart 19** Positive impact of "good" infrastructure*



Sub-components of quality- indicator: length of motorways, length of railways, fixed-line and mobile phone subscribers, broadband access, internet users, energy infrastructure, overall infrastructure

Source: BUSINESSEUROPE based on European Commission and Eurostat

Investing in information and communication technologies (ICT) and infrastructures will contribute dramatically to European competitiveness in tomorrow's knowledge-based societies. In particular, next generation networks are a key driver for jobs, growth, innovation and competitiveness in the 21st century. The timely roll-out of high-speed broadband is a key priority for Europe's economy. Investments of billions of Euros are needed to provide the necessary world-class communications infrastructure that Europe's consumers and companies need in order to compete successfully in tomorrow's knowledge-based societies.

Table 2 *Infrastructure investments foreseen in the European Economic Recovery Plan*

bn EUR	
5	trans-European energy inter-connections and broadband infrastructure project
0.5	trans-European transport projects
6	financing of climate change, energy security and infrastructure investments
5	energy efficiency, climate change mitigation and financing for municipalities and other infrastructure services

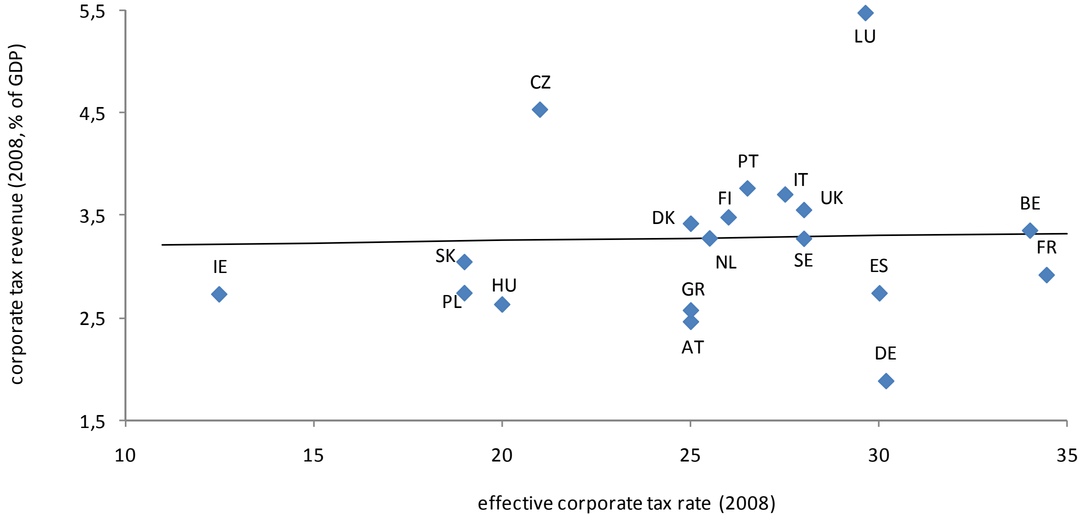
Source: BUSINESSEUROPE based on European Commission

- Measures should be taken to facilitate and encourage PPPs linked to new infrastructure and to ensure equality of treatment between private and public operation of public infrastructure and services with regard to subsidies and Community funding.
- Rules and practices should be developed to foster a liquid market for infrastructure financing
- The future ICT strategy should particularly focus on broadband coverage, investment and take-up.
- Europe should invest in next-generation networks and services to the same extent as traditional infrastructures and services.
- ICT needs to be one of the key areas in the next European strategy for growth and jobs. The future ICT policy should foster research and innovation in a competitive environment, in order to deliver optimum results towards its specific priorities for the coming years.

2.4 PRINCIPLES OF GROWTH-ENHANCING TAX REFORMS

There is an urgent need to implement tax reforms that are conducive to a high and sustained growth rate enabling job creation and thereby securing revenue bases. Increases in the tax burden – or even expectations thereof – could have a counterproductive effect and even result in a reduction of the overall tax revenues. The complexity of current tax systems and the distortive elements therein may also warrant an in-depth analysis and consideration of a shift from direct taxes to less distortive indirect taxes.

***Chart 20** Limited correlation between higher tax rates and government revenue*

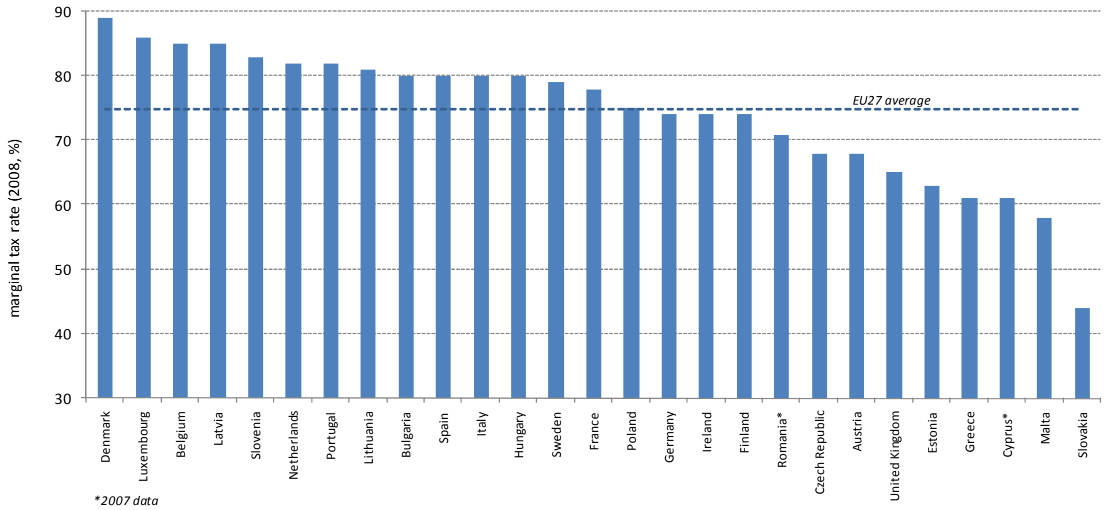


Source: BUSINESSEUROPE based on OECD

- *Provide for fair and transparent tax competition*
  Sound tax competition should be enhanced, since it provides strong incentives to improve tax systems and increase the revenue-raising capability of tax systems. Competitive tax systems make more investment projects economically viable by lowering the required pre-tax rate of return. They therefore widen the corporate tax base and create jobs and add to tax revenues.
- *Reduction of tax induced distortions*
  To the extent exemptions, reduced rates and differentiated treatment for both direct and indirect taxation are not justified by efficiency considerations, governments should review such measures. The resulting revenue should be used in a targeted way to remove distortions and to lower corporate taxes and reduce the cost of hiring. A lower corporate tax rate will also decrease the difference in financing costs between debt and equity financed investments.
- *Reduce cross-border tax obstacles*
  Rapidly increasing ECJ jurisprudence illustrates the importance of addressing tax-related obstacles to the freedom of movement of capital and the right of establishment. This concerns the tax treatment of losses in cross-border situations, how exit taxation is organised, withholding taxes on cross-border income, and anti-abuse rules.
- Submit incentives to enterprises to rigorous cost/benefit analysis and define sunset clauses. Deadweight schemes should be avoided. On expiry any consideration of renewal should be subject to fresh analysis.
- *Reduce compliance costs*
  Compliance costs linked to tax policies represent a key obstacle to economic activity. This is in particular true for SMEs. However, in the field of value-added tax, both small and large businesses suffer a considerable cost for collecting taxes and administering the system. Simpler rules and improved access to electronic invoicing are needed.
- *Avoid overlap of environmental taxes with other policy instruments*
  Environmental taxes (e.g. on energy consumption, carbon emissions, waste, etc.) are used in combination with other policy instruments (e.g. emission trading system, energy efficiency regulation, waste regulation, etc.) in many EU Member States. To ensure cost-efficiency and prevent double regulation, thorough impact assessments looking at

overlaps and inefficiencies with related instruments must be undertaken. In designing such taxes, it is important to safeguard a level playing field for sectors exposed to international competition. It is of utmost importance that taxation does not impede an efficient reduction of greenhouse gases. The reduction of such emissions must be implemented in a cost-effective manner.

Chart 21 *Tax structures favour "unemployment trap"*



The unemployment trap measures the percentage of gross earnings which is "taxed away" through higher tax and social security contributions and the withdrawal of unemployment and other benefits when an unemployed person returns to employment.

Source: BUSINESSEUROPE based on Eurostat

3. Financial stability, crisis management and public finances

Exceptional public interventions implemented since mid-2008 to safeguard financial stability and prevent the risk of systemic failures in the financial sector were necessary and have largely paid off. But the success of these interventions was based on a massive transfer of solvency risk from the financial sector to the public sector.

Table 3 *Substantial risks to public finances*

Impact of bank support schemes on			
	government debt	contingent liabilities	
		provided	ceiling
% of 2009 GDP			
Belgium	7.4	21.0	34.6
Germany	2.9	6.3	18.7
Ireland	4.2	214.8	242.0
Greece	1.6	0.6	6.1
Spain	1.8	3.1	18.9
France	3.8	1.1	16.8
Italy	0.0	0.0	-
Cyprus	0.0	0.0	-
Luxembourg	8.3	12.8	-
Malta	0.0	0.0	-
Netherlands	18.2	5.0	35.0
Austria	1.7	6.6	27.8
Portugal	0.0	3.8	12.4
Slovenia	3.6	0.0	33.2
Slovakia	0.0	0.0	-
Finland	0.0	0.1	28.1

Source: BUSINESSEUROPE, ECB

Fiscal and financial stability will be closely interconnected in the post-crisis environment.

- Timely and coordinated exit from financial sector interventions
  The withdrawal of public support in the financial sector should be based on clear, internationally coordinated criteria and must take into consideration the following four objectives:
  (i) maintain a sufficient level of financing in the recovery and be conducive to properly functioning credit channels;
  (ii) encourage banks to clean-up their balance sheets and reinforce their capital base;
  (iii) restore competition in the financial sector and encourage EU financial market integration;
  (iv) minimise the potential loss for taxpayers.

- Improve supervision to deal with systemic risks in due time
  This requires addressing the loopholes in financial market regulation and reinforcing supervision. Better macro-prudential supervision will be particularly important to identify systemic risks in due time and allow corrective measures to be taken. This will reduce the probability of financial market failures triggering large-scale economic crisis, and will hence limit further implicit liabilities weighing on national governments and taxpayers.
- Develop privately funded solutions to resolve an ongoing crisis
  Public bailout plans can also be limited by developing and stimulating privately funded solutions. This includes better and more consistent national resolution regimes, insurance schemes and convertible securities for bank creditors.
  A credible framework for winding down banks in a crisis situation would help curb excessive risk taking through greater market discipline, will provide better protection for taxpayers' money and limit the need for heavy-handed regulation.

ANNEX – BEST PRACTICE EXAMPLES

1. The role of national rules and institutions
2. Skills, education and pension reforms
3. R&D and innovation programmes

1. The role of national rules and institutions

Binding fiscal rules

- *Switzerland's "debt brake"*
  It took effect in 2003 with the objective of stabilising the nominal level of federal debt. The Swiss rule is characterised by expenditure targets which are consistent with structurally balanced budgets for each and every fiscal year. It specifies a one-year-ahead ceiling on central government expenditures equivalent to forecast revenues which are adjusted by a cyclical factor. Any deviations of actual spending from the ex post-spending ceiling are accumulated in a notional compensation account.
- *Post-crisis fiscal rule – Germany's constitutional "debt brake"*
  It will take effect from 2011 onwards with a transition period until 2016 for the federal government and until 2020 for the regional governments ("Bundesländer"), defining structural budget balance targets. In particular, the federal budget is stipulated not to exceed a deficit of 0.35 percent of GDP while the regions are obliged to balance their budgets structurally.
  To avoid pro-cyclical tightening, what this rule needs most is a sustained phase of economic recovery. Apart from this, the rule represents a crucial element of Germany's fiscal exit strategy from the crisis – and it appears to be consistent with the currently envisaged timeframe for exiting the crisis-support measures.

Non-binding fiscal rules

- *Australia (inception date of the rule: 1998)*
  The "Charter for Budget Honesty" provided a framework for the conduct of fiscal policy which required a fiscal strategy statement covering the consecutive four years be released with each annual budget. The medium-term strategy does not foresee the budget to remain in surplus in each year, to provide enough flexibility to accommodate cyclical swings in economic activity, however. An additional expenditure rule, which comes into force once the economy grows above trend, restrains real growth in spending to 2 percent a year until the budget returns to surplus.
  Results:
  Government debt ratio 1997: 37.9 % of GDP
  Government debt ratio 2007: 15.3 % of GDP
- *Finland (inception date of the rule: 1999)*
  The rule targets a structural surplus of 1 percent of potential GDP. Cyclical or other short-term deviations are permitted. The Central Government deficit must not exceed 2.5 percent of GDP.
  Results:
  Government debt ratio 1998: 60.9 % of GDP
  Government debt ratio 2007: 41.5 % of GDP
- *Netherlands (inception date of the rule: 1994)*
  The rules stipulate real expenditure ceilings for aggregate and category-specific expenditures for each year of government's four year office term. Expenditures include interest payments. If overruns are forecast, the Minister of Finance is supposed to propose corrective action. At the beginning of the electoral period, government agrees on the desired development of the tax base, and this multi-year path needs to be adhered to. Unexpected tax increases are compensated through tax reliefs and vice

versa. The budget assumptions are drawn up by an independent body. Some rules exclude public investment or other priority items from the ceiling.
Results:
Government debt ratio 1993: 96.8 % of GDP
Government debt ratio 2007: 52.1 % of GDP

- *New Zealand (inception date of the rule: 1994)*
  Government debt and net worth have to be maintained at a 'prudent' level. Operating surpluses have to be run over a 'reasonable' period of time. Fiscal targets have to be specified for 3-year and 10-year objectives, typically in percent of GDP. Rules exclude restraints on public investment or other priority items.
  Results:
  Government Debt ratio 1994: 57.4 % of GDP
  Government Debt ratio 2007: 26.2 % of GDP
- *Sweden (inception date of the rule: 2000)*
  In order to ensure that an ageing population will not encounter ever deteriorating public finances, Sweden pursues a surplus target for the general government sector, the retirement system, and the local government sector. According to the surplus target, the average annual net lending over a business cycle should correspond to 2.0 per cent of GDP. The rationale behind the surplus target is that government debt should be reduced for a period of 15-20 years before the strains on public finances, caused by a shifting age structure and a temporarily higher dependency ratio, sets in. Surpluses in the early years of this period will be offset by deficits in later years, and the ratio of government debt to GDP in 2050 is expected not to exceed the corresponding ratio in 2000, when the demographic challenge will be fading.
  Results:
  Government Debt ratio 1999: 73.7 % of GDP
  Government Debt ratio 2007: 47.9 % of GDP

2. Skills, education and pension reforms

- *Higher educational performance increases growth –Finland*
  According to PISA-scores, students in Finland have the highest performance amongst OECD countries. If the other EU member states were able to increase the educational performance of their students to the level of Finland this would increase the potential growth level of the EU year on year reaching its maximum in 2050 when the annual potential growth level would be 0.8 percentage points higher.
- *Vocational training systems – Germany, Austria and Denmark*
  The vocational training systems in Germany, Austria and Denmark include practical training in a company alternating with teaching in a vocational college. This is one way of providing a good match between the skills and competencies of young people and the needs of companies (compare with figure on youth unemployment).
- *Labour markets reforms – Netherlands*
  The Netherlands have been successful in bringing young people closer to the demands of the labour market via active labour market and training policies. But the Netherlands also have one of the lowest levels of unemployment. From the mid-nineties, a series of labour market reforms have been carried out with for example lower overall taxes on labour, simplification of the rules governing employee termination, a shortening of the maximum period of unemployment benefits and job agencies now receiving funding in accordance with the extent to which their clients become employed.

With effect of 1/1/2006 the fiscal framework for occupational retirement benefit provision was adjusted, i.e. the facilities for future accrual of retirement benefits payable before age 65 was abolished. From then on only accrual of benefits payable from age 65 is facilitated fiscally, thus discouraging early retirement. Employment rates of older works (60+) are increasing.

- *Pension reform – Norway*
  An important reason for the reform was that expenditure on old-age pension would increase very sharply with the present-day system, and that there was a need for changes to make the national insurance scheme more sustainable. The ageing of the population will result in an increasing dependency burden, as in other countries. At the same time, it is estimated that average state pension will increase over the next few years in comparison with the level of pay in society. Furthermore, the present-day pension system overall provides relatively weak incentives to stay in work, particularly for older people over the age of 62. The reformed system has a flexible retirement age from 62 but has stronger incentives to stay in the job. The pension is divided with anticipated living age. That means that if you stay longer in your job you will get a much higher pension in the remaining years. State pensions are complemented by a mandatory occupational pension and collectively agreed pension schemes.
  The reform has already proved successful and we are beginning to ripe the benefits of the new scheme. In the future the public finances will be less burdened with the pension costs of an ageing population

3. R&D and innovation programmes

The "Young Innovative Company" status that France adopted in 2004 confers tax exemptions on SMEs (fewer than 250 employees) that spend at least 15% of their total annual expenditures on R&D. These companies are exempt from all corporation tax and all capital gains tax for 8 years after their creation. These fiscal measures provide incentives for both companies and investors.
A pan-European initiative inspired by this example and aiming to give special recognition, under EU state aid rules and national fiscal policies, to young and innovative companies could boost EU innovation capacity.

This report was prepared by the High-Level Task Force on the sustainability of public finances.

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The Netherlands	Turkey	Turkey	United Kingdom		