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2002 UPDATE

OF THE CONVERGENCE PROGRAMME OF AUSTRIA

(2003-2007)

AN ASSESSMENT

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SUMMARY AND CONCLUSIONS

The new Austrian government, which was sworn in on 28 February, following the early elections of 24 November 2002, presented the update within a relatively short period of time. However, the draft budget for 2003 that would have provided more detailed quantitative information, was not available at the time of the update's submission. Moreover, the caretaker government, in office at the time, decided not to present the updated programme within the required deadlines. The update therefore complies only partly with the requirements of the revised "code of conduct on the content and format of stability and converge programmes"[6].

Within the period covered by the updated stability programme, the government plans major reforms, affecting both budgetary revenues and expenditure. Although in substance the planned measures are described in some detail, more quantitative information would have been appreciated. While partly explained by the absence of a budget for 2003 and the speedy submission of the programme update after the government had taken office, it would have been desirable to support the political reform objectives by concrete calculations and more detailed estimates of their effects. In particular, the long-term sustainability projections do not incorporate the budgetary effects of the planned pension reform, one of the programme's corner-stones, which is a major drawback of the update.

The updated Austrian stability programme has revised downwards the short-term macroeconomic outlook in comparison with the previous programme but continues to hold a favourable view on the medium-term perspective. From its cyclical trough in 2001, output growth picked up slightly to 1% in 2002 and is expected to gradually gain momentum to 1.4% in 2003 and to 2% in 2004. Thereafter, the Austrian economy is forecast to expand by 2½% per annum. Although being above trend growth as estimated by the Commission services, the projected 2.1% average growth rate over the period 2003-2007 appears feasible as fundamentals in the Austrian economy remain favourable. The short-term projections are largely similar to the Commission services' spring 2003 forecast.

In 2002, general government finances weakened markedly. From a surplus of 0.3% of GDP in 2001, the budgetary position deteriorated by almost one percentage point to a deficit of 0.6% of GDP despite the fact that output growth accelerated slightly. The cyclically-adjusted balance deteriorated by 0.6 percentage point to –0.6% of GDP according to the Commission's estimates, and according to the update amounted to –0.4% of GDP. This outcome falls short of the target set in the previous stability programme, even of the low growth scenario, which had assumed output growth close to the actual (preliminary) data. In 2001 a strong rise in revenues, mainly due to measures broadening the tax base, markedly improved the budgetary position. In 2002, by contrast, the decline in domestic demand depressed tax revenues. Relative to the budget 2002, the gross tax intake fell short of the budgeted amounts by a substantial margin, however, largely offset by a strong increase in the marginal item "other revenues", so that total revenues came in only slightly below the budgeted amount. The rise in expenditures exceeded the budgeted figure but to a smaller extent than expected after the flood disaster of last August, which had virtually no budgetary impact in 2002. Finally, statistical factors and data revisions concerning lower levels of government and social security funds, had a benign effect on the budgetary outcome.

For the years to come, the government's ambitions for budgetary consolidation have been relaxed noticeably. Before the government collapsed in September 2002, achieving and thereafter maintaining budgetary balance was one of the corner-stones of economic policy. However, the updated stability programme now foresees deficits over the entire programme period, which in three out of five year are set to exceed 1% of GDP.

The update projects the general government deficit to deteriorate from 0.6% of GDP in 2002 to 1.3% in 2003, to a large extent due to the budgetary effects of the flood disaster in summer 2002. After a temporary improvement in 2004, the deficit is forecast to widen markedly to 1.5% in 2005 owing to sizeable income tax cuts. Thereafter, the deficit is estimated to gradually narrow to 1.1% of GDP in 2006 and 0.4% of GDP by 2007. The cyclically-adjusted deficit follows the pattern of the nominal figures, due to the discretionary nature of the factors influencing the fiscal result: it widens by 0.5 percentage points in 2003 to some 1% of GDP, improves by virtually the same amount in 2004, before rising to 1.3% in 2005 due to the planned net tax relief. Despite narrowing thereafter, the deficit in structural terms remains at 1.1% of GDP in 2006 and improves by the required ½ percentage point to 0.5% of GDP only as late as in 2007.

Figures for gross government debt were significantly revised upwards, in 2001 following a Eurostat decision on securitisation operations[1], and in 2002 due to a rectification of the Austrian debt reporting related to the inclusion of bonds issued in order to finance state-owned enterprises. As a result, general government debt ratcheted up by 6.6 percentage points to 67.8% of GDP in 2002. Consequently, the decline in the debt-to-GDP ratio is significantly delayed compared with the previous version of the programme. The update expects debt-to-GDP-ratio to decrease from its peak in 2002 to slightly below the 60% reference value in 2007, while the previous version of the programme foresaw that move for 2002.

The updated government deficit projection is based on a new strategy, envisaging substantial structural savings on the expenditure side combined with sizeable tax cuts on the revenue side. In terms of expenditure cutbacks, the intended measures appear to strike a balance between short- and long-term budgetary effects. A fundamental reform of the public pension system represents the most noteworthy element of the new strategy, and would prove central to contain upward pressure on budgetary spending in the long run. The announced restructuring of health insurance funds and related measures, a further reduction in the number of civil servants, and streamlining responsibilities at lower government levels should have both an immediate and a longer term positive impact on expenditure. On the other hand, the increase in subsidies is projected to outpace nominal GDP growth by a wide margin, as a negative side-effect of budgetary hive-offs, which occurred in the past. Since these state-owned off-budget enterprises run rising deficits, government financial assistance is being stepped up.

On the revenue side, the government intends to introduce an income tax reform, entailing a sizeable reduction of the high overall tax burden, which is welcome. Yet, more decisive expenditure cuts would be appropriate, in order to prevent the cyclically-adjusted deficit from increasing markedly. Since the cyclically-adjusted deficit is forecast to be close to balance in 2004, it would be sufficient to maintain this outcome, and hence additional savings efforts would be within reach. Moreover, although the tax reform will render supply-side conditions more growth-friendly, an eventual increase in tax allowances or the introduction of preferential tax treatments might counteract the base-broadening measures implemented recently and add some complexities to the tax system. Finally, in the light of the rapidly closing, albeit still slightly negative output gap in 2005, the tax relief might prove pro-cyclical.

1 Decision of Eurostat on deficit and debt, nr. 80/2002 of 3 July 2002: “Securitisation operations undertaken by general government”

The government deficit projections hinge crucially on the successful implementation of the planned savings measures. Any shortfalls in this respect would cause the estimated budgetary outcome to deviate further from balance, unless the tax reform were downsized to match expenditure overruns. Therefore, the main risk to the government's strategy relates to an asymmetric implementation of the expenditure and revenue side measures. If the planned savings were realised only partially and the tax relief fully implemented, the budgetary leeway would be insufficient to withstand a normal cyclical downturn without discretionary counter-action.

Against this background, and given that Austria's debt still exceeds 60% of GDP, a departure from a balanced budget for two years in 2005 and 2006, does not seem appropriate. Once Austria will have attained a budgetary position close to balance, it should endeavour to maintain it as of 2004. This implies, as a first step, that the envisaged structural expenditure savings, in particular relating to the pension and health care reform, need to be fully implemented. In addition, the income tax reform ought to be made contingent on additional expenditure reductions. Past experience has shown that cutting taxes without ensuring commensurate expenditure restraint is a risky strategy.

As in the previous programme, significant consolidation efforts are required at the level of the Federal States ("*Bundesländer").* In the framework of the revenue sharing scheme *("Finanzausgleich")* between federal and local governments valid until 2004, the *Bundesländer* committed themselves to run annual budget surpluses of on average 0.75% of GDP. Although these targets are binding and should be ensured by the internal stability pact, this obligation is temporarily suspended due to last year's flood disaster, i.e. not taking account of flood-related expenditure in the years 2002 and 2003. Therefore, according to the update, the average surplus target will not be attained for the period 2001-2004. However, the revenue sharing scheme for subsequent years, subject to negotiations which have not yet started, should extend this obligation. In the years to come, expenditure savings have to be stepped up significantly at the regional and local level in order to achieve these high surpluses. While the update describes some measures implemented so far, the necessary additional savings remain largely unspecified.

Under the projected path of the government balance, Austria complies only partly with the requirements of the Stability and Growth Pact, in 2003, if corrected for flood-related spending, 2004 and in 2007. In these years, the government accounts in cyclically-adjusted terms are projected to be close to balance. In the other years of the programme, the cyclically-adjusted deficit either widens by a substantial margin or does not improve by at least 0.5% of GDP. Nevertheless, given the revealed relatively low elasticity of the budgetary outcome to the economic cycle in Austria, government finances – under the projected path - should be able to withstand a normal cyclical downturn without breaching the 3% of GDP reference value for the deficit ratio. The general government debt is projected to fall gradually to slightly below 60% of GDP by 2007.

By contrast, if the announced expenditure savings were only partly implemented -which represents the main risk to the government's strategy-, the deficit in 2005 would exceed the "minimum benchmark value", estimated by the Commission services at 2.1 % of GDP. Hence, in a scenario of only partial expenditure cuts, Austria would not have sufficient budgetary leeway to let the automatic stabilisers work fully in the event of a normal cyclical downturn.

As regards the long-term sustainability of public finances, the Commission considers the assessment provided in the stability programme as complacent. On the basis of current policies, the risk of unsustainable public finances in terms of emerging budget imbalances cannot be excluded. This is attributable to the high initial level of public spending on pensions, amounting to some 15% of GDP, and its projected increase, to a level that would be well above that observed in most EU countries. A further element of risk is the planned reduction of primary surplus during the programme period.

To this end, Austria should pursue a budgetary position "close to balance or in surplus" during the next few years, to prepare for the likely impact of ageing population. In combination with health care restructuring, the pension reform is a central element to rendering the government finances sustainable in the longer term, as recommended in the Broad Economic Policy Guidelines, since the measures outlined in the update address many of the key problems

The programme refers to ongoing reforms on product, capital and labour markets. Good progress has been made in certain areas, such as network industries, competition law, financial market supervision, and establishing an employee pension scheme. Despite recent success, further efforts will be needed to render product markets more flexible, and in particular to enhance competition, as well as to increase capital market efficiency.

1. INTRODUCTION

The Austrian Council of Ministers adopted the update of the Austrian stability programme on 25 March 2003. The update extends the programme period by two years and covers the period up to 2007. This is the fourth annual update of the programme originally presented in November 1998. The programme has been sent to the Austrian Parliament for information and is also being made available to the general public[2].

The previous programme contained a fiscal consolidation plan for the period 2001-2005 and was assessed by the Commission and the Economic and Financial Committee. The Council gave its opinion[3] on 22 January 2002.

The Council, in its opinion on the stability programme 2001, considered a decisive decline in the tax burden instrumental in rendering government finances more conducive to employment and output growth, an aspect that the updated programme addresses. The Council, however, emphasised that revenue reductions should not be allowed to compromise the budgetary targets. Furthermore, the Council considered a budgetary surplus in the medium term central in bringing down the debt level decisively, in particular in view of the long-term expenditure pressures resulting from population ageing.

The budgetary strategy of the updated stability programme has changed significantly compared with its previous version. The previous programme had a short-term focus, aiming at attaining budgetary balance and moving to a small surplus. The update, by contrast, concentrates on long-term issues, outlining in particular a fundamental reform of public pensions as well as envisaging structural changes in the health care sector. In addition, the programme announces a substantial tax reform intended to reduce the high tax burden. However, the previous target of maintaining budgetary balance, emphasised by the previous programme, is abandoned.

Indeed, the update projects the general government financial position to deteriorate, both in nominal and in cyclically-adjusted terms. The general government deficit will remain on average at 1% of GDP throughout the projection period, which is in contrast to the objective of the previous programme aiming at a small surplus.

2 The programme has been made available, inter alia, on the internet page of the Austrian Ministry of Finance (http://www.bmf.gv.at/service/publikationen/download/berichte/stab03-07.pdf German text, http://www.bmf.gv.at/ministerium/ministerium/englisch/pub/st2007en.pdf English version)

3 OJ C33/5, 6.2.2002

As regards local governments, the update confirms their commitment to achieve substantial structural surpluses, which should in principle be ensured by a national stability pact but necessitates additional expenditure savings.

2. IMPLEMENTATION OF THE NOVEMBER 2001 STABILITY PROGRAMME

Budgetary data for the year 2001 were revised and final figures indicate that government finances improved even more strongly than was known so far. Despite the considerable slowdown in growth to a cyclical trough, the general government financial position moved to a surplus of 0.3% of GDP, improving by a strong 2.1 percentage points in nominal terms and by as much as 2.8 percentage points[4] in cyclically-adjusted terms.

In 2002, by contrast, general government finances weakened markedly. The budgetary position deteriorated by almost one percentage point to a deficit of 0.6% of GDP, although output growth picked up somewhat to 1.0%, according to preliminary GDP data. This outcome falls short of the initial objective of a balanced budgetary position set in the November 2001 stability programme based on a real growth assumption of 1.3% and also exceeds the deficit target of -0.2% of GDP retained in the low-growth scenario assuming a real GDP expansion of 0.9%, close to actual, if preliminary data.

While in 2001 a strong rise in revenues, mainly due to discretionary measures broadening the tax base, improved the budgetary position, the drop in domestic demand depressed the tax intake in 2002. Revenue from major taxes (income, corporate, wage related, and value added tax) accounting for more than three quarters of the total, fell short of the budgeted amounts by almost 5%[5]. This effect was partly compensated, such as by an increase in revenues from energy taxes. As a result, gross tax revenue, accounting for 97% of total revenues in the budget for 2002, came in below the budgeted amounts by 3.2% or 0.8% of GDP. Although to a considerable extent caused by the particular weakness of domestic demand components, a negative "echo-effect" related to the tax regime shift in 2001, introducing interest charges on tax arrears, cannot be excluded. The deterioration of the cyclically-adjusted balance by 0.6 percentage points would actually support this reasoning.

Overall, total revenues came in only slightly below[6] the budgeted amounts (by -0.1% or 0.03% of GDP) due to the marginal item "other revenues" which, however, rose strongly, such as to offset most of the shortfalls in tax income. As a consequence, the revenue-to-GDP-ratio decreased by 0.8 percentage points in 2002 to 51.5%, with taxes and social charges amounting to 46.1% of GDP (see Table 3 on page 9).

On the expenditure side, rising unemployment and almost stagnating employment, entailed lower pension insurance contributions and thus higher federal outlays for public pensions. As a consequence, total spending[7] exceeded the budgeted figure by 2.3% or 0.6% of GDP. The expenditure overruns, however, were lower than anticipated, following the flood disaster in summer 2002. The latter had virtually no budgetary impact in 2002, although a sizeably

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4 Figures are corrected for UMTS sales in 2000: The nominal deficit in 2000 amounted to 1.5% of GDP and excluding UMTS proceeds to 1.8% of GDP.

5 All figures comparing outcome with the budget 2002 are on a cash basis (not accruals) and relate to the central government. Central government controls basically all revenues, while lower levels of government have extremely limited power over revenues but control certain expenditures.

6 The total revenue figures was corrected for additional but earmarked funds relating to the flood disaster in August 2002 (€ 0.5 billion) and labour market measures (€ 0.2 billion), which inflated both revenues and expenditures by an equal amount but had thus a neutral effect on the budgetary result

7 On a cash basis on the central government level.

emergency package[8] was expected to increase spending. Overall, the expenditure-to-GDP-ratio rose marginally by 0.1 percentage point to 52.1% (see Table 3 on page 9).

Finally, statistical effects and, despite a decline in the surplus, better-than-expected results for lower levels of government in 2002 and revised for 2001, as well as revised 2001 data for social security funds totalled +0.4 percentage points of GDP, and thus partly offset the negative budgetary effects described above. The debt-to-GDP-ratio was significantly revised upwards for the year 2001 following a Eurostat decision on securitisation operations and for 2002 due to the inclusion of debt issued for public enterprises ("Rechtstragerfinanzierung") which had been omitted. As a consequence the debt-to-GDP ratio increased by almost 7 percentage points to 67.8% in 2002 (more details see section "Debt ratio" on page 4).

3. THE MACROECONOMIC SCENARIO

3.1 External economic assumptions

The programme's external assumptions are close to those used in the Commission's spring forecast, with two exceptions: the update's oil price assumptions are above the Commission's forecast for 2003 and slightly below for 2004, and the update's long-term interest rate assumptions are higher in 2003 and 2004. Some assumptions, however, are not made explicit (e.g. world, EU-15 GDP growth, growth of foreign markets).

3.2 Macroeconomic developments

The slack in Austrian GDP growth is projected to continue in 2003 with output expanding by 1.4% before picking up to 2.0 % in 2004. These projections are substantially lower in than in the previous version of the programme, by a full percentage point in 2003 and 0.8 percentage point in 2004. In the three final years of the programme, output growth is expected to accelerate to 2½%. The small negative growth contribution from domestic demand is expected to be reversed in 2003, reaching 1.0%, and to rise further thereafter. Conversely, the growth contribution of net exports is expected to halve in 2003 to ½ percentage point and to remain broadly unchanged over the later years of the forecast period. Dependent employment is projected to expand very briskly by 0.7% in 2003, despite the delayed upswing. Price inflation (HICP) is forecast to decrease slightly from 1.7% in 2002 to 1.6% in 2003 before rising to 1.8% in 2004, due to a planned increase in energy taxes, and drop somewhat thereafter. Expected wage increases reflect the underlying growth assumptions, with pay rises accelerating gradually in 2004 and 2005. On average, wages per head should rise at around 2½% annually over the forecasting period. This implies increases in nominal unit labour cost of 0.8% in 2003 and around 1% for the remainder of the period. As to the current account, the programme expects the quite exceptional, if small, surplus in 2002 to turn into a deficit again in 2003, widening to -0.5% of GDP as of 2005.

8 Totalling some 0.6% of GDP in Maastricht-terms, to be spent in 2002 and 2003, with the main impact in 2003 and negligible revenue shortfalls in 2004 and 2005.

Table 1: Macroeconomic scenario – forecast comparison

Economic Forecasts 2001-2003 (Annual average growth rate, in %)							
	2001	2002		2003		2004	
	National Accounts	**Stability Program** 1)	**ECFIN Spring** 2) c)	**Stability Program** 1)	**ECFIN Spring** 2)	**Stability Program** 1)	**ECFIN Spring** 2)
GDP	0.7	0.9	1.0	1.4	1.2	2.0	2.0
Private consumption	1.5	0.6	0.9	0.9	1.2	1.6	1.9
Exports (Goods & Services)	7.4	0.8	2.6	3.4	4.3	4.7	7.1
Imports (Goods & Services)	5.9	-1.1	0.0	2.6	4.5	4.2	7.5
GDP deflator	1.6	1.1	1.3	1.6	1.1	1.5	1.5
HICP	2.3	1.7	1.7	1.6	1.8	1.8	1.8
Employment growth a)	0.5	0.2	-0.4	0.7	0.0	0.5	0.4
Unemployment b)	3.6	4.1	4.3	4.1	4.5	4.0	4.4
Budget Surplus (% of GDP)	**0.3**	**-0.6**	**-0.6**	**-1.3**	**-1.1**	**-0.7**	**-0.4**
Debt (% of GDP)	**67.3**	**67.8**	**68.7**	**67.0**	**68.5**	**65.1**	**66.8**

SOURCES: Austria; Federal Ministry of Finance, Commission Services

a) Stability programme: dependent labour, including persons on parental leave
ECFIN forecast: effective dependent employment, ESA 95 definition
b) % of labour force
c) preliminary national accounts data

1) March 2003 2) April 2003

The short-term projections are close to the Commission services' spring forecast in most variables. However, a noticeable difference concerns dependent labour, in particular in 2003. The Commission forecasts dependent employment to grow by 0.1% in 2003, while the Austrian authorities indicate a marked rise of 0.7% The data, however, are not comparable. The Austrian figure included persons on parental leave, which explains the brisk expansion. This does not correspond to the ESA95 definition and therefore does not reflect the underlying labour market developments. By contrast, in order to calculate labour productivity, the Austrian authorities used data in the ESA95 definition, assuming dependent labour to stagnate in 2003. Also for the calculation of social contributions for the budgetary outlook, employment growth in ESA95 definition was used. It would have been better if the figures on employment growth presented in the table on macroeconomic assumptions were the same as the figures used for the calculations but are not made specific in the update.

As regards the medium-term outlook, real GDP growth rates of 2½% as of 2005 could be attained, despite being above potential output growth, currently estimated at 1.6% for 2004 by the Commission services. It appears, nevertheless, reasonable to assume that, after a period of slow growth, the output gap closes and turns positive, not least due to the planned structural reforms which should render supply-side conditions more growth-friendly and could potentially increase employment rates. The update's assumptions result in an average annual growth rate of 2.1% over the period 2003-07. Although this is higher than the trend growth rate as estimated by Commission services, the divergence in the results is inherent to the calculation method[9]. Therefore, despite the fairly subdued short-term prospectives, the more favourable medium-term outlook for the Austrian economy seems justified for the following reasons: First, no important imbalances in the economy are to be expected. In

9 According to a derogation for Austria, trend growth continues to be calculated but by the HP-filter and not by the Commission's production function method. The HP-Filter attaches virtually all weight to the last four data input points and, in order to correct for the end-of-series bias, assumes that the output gap closes over the projection period of four years. The Commission spring forecast goes up to 2004, hence the low GDP growth rates in the years 2001-2004 result in a low trend growth as shown in Table 4 on page 13. Conversely, the updated stability programme provides data points up to 2007 with distinctively higher growth rates, resulting in higher trend growth.

particular, social partners are likely to continue their policy of setting wages in line with maintaining international competitiveness. Second, according to various studies EU-enlargement is expected to provide a significant fillip to the Austrian economy. A decisive, and possibly limiting factor, however, is a favourable growth performance of Austria's main trading partners.

Last but not least, the substantial structural reforms, as outlined in the programme, could boost consumer and business confidence in the medium term, although in the short term their impact might be ambiguous, in particular due to increased uncertainty during the political debate on a pension reform.

The macro-economic scenario presented in the update, therefore, appears plausible.

4. BUDGETARY TARGETS AND MEDIUM TERM PATH OF PUBLIC FINANCES

4.1 Programme overview

The updated programme projects the deficit to deteriorate from 0.6% in 2002 to 1.3% of GDP in 2003 despite higher output growth. After temporary improvement in 2004, the planned income tax reform is forecast to boost the deficit as of 2005, when it is estimated to increase to 1.5% of GDP and to remain above 1% of GDP in 2006. A sizeable improvement to a deficit of 0.4% of GDP is forecast only for 2007. In comparison with the previous programme covering the period up to 2005, the new objectives represent a marked deterioration.

Table 2: GDP growth and general government balance: The November 2001 and the March 2003 programmes compared

	%	2002	2003	2004	2005	2006	2007
Real GDP growth	**November 2001**	1.3	2.4	2.8	2.8	-	-
	March 2003	0.9	1.4	2.0	2.5	2.5	2.4
	Difference	*-0.4*	*-1.0*	*-0.8*	*-0.3*	-	-
Net lending/borrowing	**November 2001**	0.0	0.0	0.2	0.5	-	-
% of GDP	**March 2003**	-0.6	-1.3	-0.7	-1.5	-1.1	-0.4
	Difference	*-0.6*	*-1.3*	*-0.9*	*-2.0*	-	-
Source: updated stability programmes of March 2003 and November 2001							

The budgetary strategy has changed significantly compared with the previous programme. Noteworthy are in particular two key government projects: (1) a fundamental reform of the public pension system, tackling many of its key problems, which is without doubt the most remarkable feature of the updated stability programme and (2) a major tax reform intended to reduce the tax burden from its peak of almost 46% in 2002 to 43% of GDP by the year 2006.

On the expenditure side, the updated programme projects cumulated savings until 2006 to total some 2¼% of GDP. In addition to the pension reform, the reduction in the number of civil servants is to be continued. Further reforms target the health care, the federal railways as well as lower levels of government. On the revenue side, the sizeable tax reform is envisaged to cost € 3 billion or 1.3% of GDP and take effect in two steps in 2004 and 2005. Moreover, structural reforms in labour, product and capital markets and further privatisations of public enterprises complement the new strategy.

In qualitative terms, the updated programme presents several measures in some detail, such as the planned reform of the pension and health care system. For other measures - in terms of their budgetary effect equally important –little specifications are given. In quantitative terms, however, more information would have been appreciated.

Therefore, as a general feature of the updated programme, quantitative indications regarding particular measures represent political objectives rather than estimates. Too few of the measures were planned in sufficient detail at the time when the update was submitted, only a month after the government had taken office. It would have been desirable, however, to support the quantitative political targets by concrete calculations and more detailed estimates of their effects.

Having this in mind, the stability programme expects total revenues to increase on average by 2.7% annually over the period 2003-07, which is almost one percentage point below the projected average nominal GDP growth of 3.6%. As a consequence, the revenue-to-GDP ratio is expected to drop by 2.1 percentage points from 2002 to 49.4% in 2007 (see Table 3). The tax burden is forecast to fall by as much as 1.7 percentage points to 42.9% of GDP in 2007 due to the tax reform. Total expenditure is estimated to rise at the same pace as total revenue, by 2.7% per year over the programme period, also below nominal GDP growth. As a result, total expenditure as a percentage of GDP is expected to decline by 2.3% percentage points to below 50% in 2007.

Table 3: Revenue and expenditure projections

	as % of GDP	2001	2002	2003	2004	2005	2006	2007
Update 11/2001	**Total revenues**	52.6	51.5	50.8	50.4	50.3	-	-
	Total expenditure	52.6	51.5	50.8	50.3	49.8	-	-
	Tax and social charges [1)]	47.1	46.3	45.7	45.5	45.5	-	-
	Primary expenditure [2)]	49.2	48.2	47.7	47.3	47.0	-	-
03/2003 (*)	**Total revenues**	52.3	51.5	51.1	50.8	49.5	49.4	49.4
	Total expenditure	52.0	52.1	52.4	51.6	51.0	50.5	49.8
	Tax and social charges [1)]	46.8	46.1	45.6	45.4	44.1	44.1	44.1
	Primary expenditure [2)]	48.2	48.4	48.8	48.1	47.6	47.2	46.6

1) Taxes and social contributions
2) Total expenditure minus interest payments
(*) ratios calculated on basis of revised GDP assumptions as projected in March 2003 programme
Source: Austrian stability programmes (March 2003 and Nov. 2001), Commission services.

4.2 Public Finances in 2003

At the time when the updated stability programme was submitted, the budget for 2003 had not yet been drafted due to delays in the formation of a government[10] after parliamentary elections in November 2002. As a consequence, the update contains only very limited qualitative and quantitative information, notably on the reform projects intended by the government.

The authorities project the deficit in 2003 to more than double, widening to 1.3% of GDP after 0.6% in 2002, and the cyclically-adjusted deficit is forecast to deteriorate by ½ percentage point to 0.9% of GDP. To a large extent a one-off factor is responsible for this deterioration, namely the flood disaster in August 2002.

10 Elections took place on 24 November 2002, the government – a coalition between ÖVP and FPÖ – was sworn in on 28 February 2003.

The fiscal year 2003 is characterised by several factors: First, the budget for 2003 will take effect only as of July. The delay in adopting the regular budget renders time for policy action particularly short, similar to the year 2002 when Parliament dissolved in mid-September In the first half year, a provisional budget[11] is in force, limiting nominal expenditure by imposing a monthly ceiling corresponding to 1/12th of the previous year's total expenditure. In addition, the Council of Ministers decided to cut ministries' budgetary envelopes by 5% across-the-board compared with the budget 2002 (or by 2% compared with the lower-than-budgeted outcome in 2002), corresponding to estimated savings of some € 360 million or some 0.15% of GDP. These spending ceilings should actually facilitate budgetary consolidation and contribute to lower the deficit in 2003.

Second, the 2002 flood disaster is expected to result in higher budgetary spending and in revenue shortfalls in 2003. The government had passed a generous emergency aid package, totalling some 0.6% of GDP, which had virtually no budgetary impact in 2002. Contrary to expectations only some 0.1% of GDP were released in 2002. Therefore, the remaining funds are projected to increase the deficit by 0.45% of GDP. There seems to be a chance, however, that not all of these funds are called upon.

Third, two fiscal packages[12] are estimated to burden the budget by some ¼ % of GDP on a permanent basis as of 2003, although they were labelled "economic stimulus" packages, suggesting only temporary budgetary implications. This partly offsets the continued alleviating effects of the pension reform 2000 and of the reduction of civil servants.

Fourth, public sector employees are being granted an additional pay rise, making up partly for past purchasing power losses due to particularly moderate wage increases in 2002 and 2001.

According to the Commission's spring forecast, these factors are topped by the expected delay in the cyclical upswing and hence employment growth, entailing slightly rising unemployment. In its spring exercise, the Commission forecasts the deficit in 2003 to widen to 1.1% of GDP, under the assumption that not all of the flood-related emergency funds will be spent. The debt-to-GDP ratio is forecast to decline slightly to 68.5%.

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11 The provisional budget law for the year 2003 was agreed upon by the Council of Ministers of the caretaker government on 28 January 2003 and adopted by parliament on 27 March 2003. The provisional budget replaced the automatic constitutional rules (as laid down in B-VG Art 51, Abs 5, Zi 2.) but cannot be considered a full-fledged budget. In absence of a budget law, the constitution imposes a ceiling on nominal expenditure, freezing monthly spending at 1/12th of the previous year's total expenditure, while respecting new laws modifying revenues and expenses. In addition, the constitution restricts debt issuing to half of the previous year's level, normally reached already in May. A provisional budget differs from the constitutional rules by providing a legal basis for issuing debt up to 100% of the previous year's level, thereby counteracting the latent liquidity problem. The monthly spending ceilings, however, remain compulsory.

12 Adopted in December 2001 and September 2002 in the light of the cyclical downturn; intended to temporarily increase private investment and foster human capital formation and innovation by preferential tax treatment. In addition, a new pension savings scheme was introduced, aiming at strengthening the third pillar of the pension system.

4.3 Targets and adjustment in 2004 and beyond

- *Expenditure*

In particular, the pension reform is central to ease upward pressure on budgetary spending in the long run. Planned to start in 2004 and to be phased in until 2009, the pension reform should result in cumulated savings of 0.5% of GDP by 2006, according to the political goal. Because of the pension reform's continued and cumulating exonerating effects thereafter, it represents a key element of the long-term budgetary strategy presented in the updated stability programme.

Similarly, the announced reform of health insurance funds and streamlining responsibilities between provinces and local authorities, are each intended to result in savings in the same magnitude (0.5% of GDP by 2006). In addition, the envisaged reform of public administration, consisting mainly in further cuts in personnel, is planned to reduce spending by 0.6% of GDP until 2006. Last but not least, restructuring the federal railways is projected to diminish expenditure by 0.1% of GDP (by 2006).

As a consequence, the expenditure-to-GDP-ratio is forecast to decline gradually to 49.8% in 2007 from its peak of 52.4% in 2003. Given that little quantitative information, other than in cumulative terms, is presented in the update, it is difficult to assess whether the savings plans, in particular those to be phased in, would result in a marked drop in the expenditure-to-GDP-ratio as early as of 2004.

In sum, the intended expenditure savings appear to strike a balance between short- and long-run budgetary effects. Staff reductions and measures aiming at increasing the efficiency in the health care system not only have an immediate positive impact on the budget but also longer term effects. The planned steps towards increasing cost transparency in public administration and enhancing patients' cost awareness concerning health care services, should improve financial discipline. Particularly welcome is the intention to dismantle duplication in public administration at the lower levels of government. In combination with the long-run impact of the planned pension reform, this should translate into a sizeable drop in expenditure over the long term.

On a less positive side, subsidies, representing some 3% of GDP, are projected to rise substantially, by 5.0% on annual average over the forecasting period, thereby clearly outpacing average nominal GDP growth (3.6%). The updated stability programme, however, does not comment upon this aspect. Financial assistance to state-owned off-budget enterprises, which run rising deficits, is the driving force behind this marked increase. This is clearly a negative side-effect of budgetary hive-offs, which occurred in the past. To some, albeit fairly small extent, assistance to farmers also contribute to the rise in subsidies.

Similarly, the update does not mention a key element of the health care reform, namely the merger of sickness funds, although this is explicitly announced in the government programme. Streamlining the currently split up health insurance funds could, however, prove central to attain the targeted savings.

A major drawback of the updated programme is the fact that the long-term sustainability projections do not incorporate the budgetary effects of the pension reform. Clearly, this would have been warranted given the importance of the reform.

- *Revenue*

On the revenue side, the tax reform is planned to entail a net relief of 1.3 % of GDP and to take effect in two steps: a smaller one in 2004, amounting to € ½ billion or 0.25% of GDP, and a major one in 2005, amounting to € 2½ billion or more than 1% of GDP. The envisaged reform consists of lowering taxes for low and middle incomes through higher tax allowances, introducing preferential taxation for retained profits, creating work incentives for lower incomes, reducing non-wage labour costs, in particular for older workers, and abolishing the 13^{th} month VAT prepayment. Last but not least, the tax system is said to become more environment-friendly. This circumscribes the announced increase in energy and mineral oil taxes as of 2004, with a view to aligning energy taxation to the EU average. Although not indicated in the updated stability programme, the Austrian finance ministry estimates revenues to rise by € 430 million or 0.2% of GDP in 2004. Nevertheless, having stood at 51.5% in 2002, the revenue-to-GDP-ratio is forecast to fall rather markedly already in 2004, when the first step of the tax relief will take effect, to drop considerably in 2005 by 1.3 percentage points to 49.5% and to remain virtually unchanged thereafter.

In principle, the government's plans to significantly cut back taxes as of 2004 is a welcome step towards lowering the tax ratio, which had increased sharply due to the revenue side consolidation in 2001. Such a reform, and in particular the reduction of non-wage labour costs, which had repeatedly been postponed, could render supply side conditions more growth friendly.

Yet, the envisaged tax reform has three shortcomings in terms of (1) budgetary outcome, (2) substance and possibly (3) timing. First, such a substantial tax relief should be financed by more decisive action on expenditure side. The planned deterioration of the cyclically-adjusted deficit by 0.9 percentage points to 1.3% of GDP in 2005 should be avoided. Given that in structural terms the planned budgetary position in 2004 can be considered as close to balance, the government should strive to maintain this outcome. This would, however, require sizeable additional saving measures, which are not foreseen in the updated programme.

Second, while the tax measures in 2000 and thereafter broadened the tax base, the new plans would run counter this achievement. Enhancing transparency is not an explicit objective, although this would have been welcome. , On the contrary, tax exemptions or allowances generally tend to increase the system's complexity.

Third, as the output gap is closing, although projected to be still slightly negative in 2005, the substantial net tax relief risks to have a pro-cyclical effect, since the Austrian economy is forecast to expand at full cruising speed by 2005. This growth outlook supports not only the need for but would also facilitate expenditure restraint.

At the level of the Bundesländer, significant surpluses are required to comply with the revenue sharing scheme ("Finanzausgleich"), valid until 2004. The surplus target was downsized by ¼ p.p. to an average annual of 0.5% of GDP for the period 2001-2004. For the time being it remains unclear whether this will entail financial sanctions for the Länder, as foreseen in the national stability pact. As far as flood-related expenditure in 2002 and 2003 is concerned, the pact is temporarily suspended, and until 2004 Länder could in principle make up for any under-performance occurred so far. In any case, lower government levels will need to step up their savings efforts considerably, in order to attain surpluses of ¾ of GDP on average as of 2005, when a new revenue sharing scheme – yet to be negotiated – will be in force. Disentangling responsibilities between provinces and local authorities is a welcome step.

The budgetary objectives for 2004 and beyond hinge crucially on the successful implementation of the planned expenditure cuts, planned to result in cumulated savings of 2.2% of GDP until 2006. Even if these measures were realised to their full extent, the deficit is projected to increase noticeably after 2004, both in nominal and in cyclically-adjusted terms. Under the assumption that the tax reform will be as costly as announced, any shortfalls with regard to spending cuts, would cause the estimated budgetary outcome to deviate further from budgetary balance.

The main risk to the government's strategy is that expenditure savings may not be realised to their planned extent, while the tax relief, by contrast, materialises as envisaged. Clearly, the main challenges relate to the full implementation of the savings plans and are thus on the political side. In particular, the pension reform, although vital for the long-term budgetary sustainability, might face brisk opposition. Thus, there is a risk that the government might scale down its savings plans.

- *the cyclically-adjusted deficit path*

When adjusting government finances for the influence of the cycle, the Commission method applied on the updated programme's projections and the calculations presented in the Commission services' spring forecast return similar results with only minor differences. In 2002, the cyclically adjusted balance deteriorated noticeably, by 0.6 percentage point to -0.6% of GDP.

Table 4: Cyclically adjusted public finances (CAB)

	Stability Programme				Spring Forecast			
	Budget balance	GDP growth	HP Trend growth *	CAB	Budget Balance	GDP Growth	HP Trend growth *	CAB
2001	--	--	--	--	0.3	0.7	1.9	0.0
2002	-0.6	0.9	2.0	-0.4	-0.6	1.0	1.8	-0.6
2003	-1.3	1.4	2.0	-0.9	-1.1	1.2	1.7	-1.0
2004	-0.7	2.0	2.0	-0.4	-0.4	2.0	1.6	-0.4
2005	-1.5	2.5	2.1	-1.3	--	--	--	--
2006	-1.1	2.5	2.1	-1.1	--	--	--	--
2007	0.4	2.4	2.1	-0.5	--	--	--	--

* According to a derogation for Austria, trend growth is not calculated by the Commission's production function method but by the HP-filter
Source: Stability programme March 2003, Commission services' spring forecast 2003

The projected deficit path indicates that Austria starts moving away from budgetary balance as of 2003 and, with the exception of 2004, will not return to a closer to balance position before 2007. The calculations indicate that the cyclically-adjusted deficit widens markedly by as much as 0.5 percentage points in 2003, owing to the discretionary factors discussed earlier (floods, fiscal stimulus packages), to 0.9% (update) or 1.0% (ECFIN) of GDP. In 2004, a temporary improvement in the same order of magnitude is expected, as a positive counter-effect of flood-related spending a year earlier, in spite of the first step of the tax reform, amounting to a net tax relief ¼ % of GDP and taking effect as of January. The tax reform's more costly second step (more than 1% of GDP) in 2005 should entail a substantial deterioration of the cyclically-adjusted deficit by almost 1 percentage point to 1.3% of GDP. In 2006, although the deficit in cyclically adjusted terms is estimated to start narrowing again, the expected improvement is less than 0.5% of GDP as agreed for those countries which have not yet attained a budgetary position close to balance. Finally, a deficit in cyclically adjusted terms of some ½ % of GDP will persist in 2007, the same as in 2003.

Under the projected path, government finances in Austria would comply with the "close-to-balance" requirements of the Stability and Growth Pact only in 2004 and in 2007, when the general government deficit is projected at or below 0.5% of GDP.

Nevertheless, given the revealed relatively low elasticity of the budgetary outcome to the economic cycle in Austria, the calculations indicate that government finances under the projected path would have a sufficient safety margin to withstand normal cyclical fluctuations without breaching the 3% reference level of the Stability and Growth Pact throughout the programme period.

If, however, structural spending cuts were only partly implemented, the deficit in 2005 would reach the benchmark value calculated for Austria, beyond which Austria would risk to breach 3% deficit threshold in the event of a normal cyclical downturn.

4.4 Sensitivity analysis

The programme includes alternative scenarios based upon lower and higher growth assumptions to assess the consequences for public finances. The scenario assumptions, however, are somewhat unorthodox. First, the assumed growth rates for the low and high growth scenario do not diverge symmetrically, or even do not diverge at all, from the baseline. Second, the growth rate divergence from the baseline within a scenario varies over the years, not always for obvious reasons. Third and most important, the estimated impact on the budgetary position does not seem to correspond to the respective growth assumptions, generally overstating the effects on public finances.

More specifically, the high growth scenario is identical to the baseline in 2003 and 2004, which is at odds with the purpose of the exercise. In 2005, by contrast, GDP growth is 0.7 percentage points above the baseline, assuming that the tax reform and structural reforms boost economic activity. As a result, the deficit ratio is estimated to turn out 0.2 percentage points lower than in the baseline setting, implying a budget elasticity of 0.3 with respect to real GDP growth, which corresponds to calculations by the Commission services and the OECD. As of 2006, the deviation in output growth narrows, amounting to only 0.1 percentage point in 2007. The deficit, however, is estimated to improve by as much as ½ percentage point in 2007, suggesting an implicit budget elasticity of 5.0, which is unrealistic.

In the low growth scenario, real GDP is assumed to expand by 0.3-0.4 percentage point less p.a. than in the baseline. Although the growth differential is basically constant, the assumed impact on the deficit varies from 0.1 to 0.5 percentage point, which does not appear plausible.

To sum up, while the inclusion of a sensitivity analysis for different growth assumptions is welcome, the estimates presented in the updated programme appear to be of limited analytical value added.

A high interest rate scenario is not included, for comprehensible reasons as regards the direct budgetary impact. Average debt maturity stood at 6 years at the end of 2002 and interest rates on roughly 90% of public debt are fixed. Therefore, interest sensitivity of government finances is quite limited.

4.5 Debt ratio

The debt-to-GDP-ratio was significantly revised upwards (1) in 2001 following a Eurostat decision[13] on securitisation operations and (2) in 2002 due to the inclusion of debt issued for public enterprises which had been misclassified. First, Eurostat's decision on securitisation operations entailed a reclassification of debt within the government sector and resulted in an increase of public debt by € 2593 million or 1.2% of GDP in 2001. The second reclassification concerned bonds issued by the Austrian government in order to finance public enterprises ("Rechtsträgerfinanzierung"), which had not been recorded as government debt. At the end of 2002, these operations amounted to € 11.7 billion or 5.4% of GDP. Thus, the total effect of these two revisions is an increase in the debt-to-GDP-ratio by 6.6 percentage points in 2002.

As a consequence, reaching the 60% threshold of the debt-to-GDP ratio is delayed compared with the previous version of the programme. While the previous programme had projected the debt-to-GDP-ratio to drop below the 60% benchmark in 2002, the updated stability programme expects it to fall below the 60% reference value only in 2007. The debt ratio should decline by more than 8 percentage points from its peak in 2002 to 59.7% of GDP in 2007.

Key cause for the relatively speedy improvement of the debt ratio until the end of the programme period is that the government will cease to finance public undertakings. State-owned enterprises will gradually reimburse accounts outstanding from these financing operations ("Rechtsträgerfinanzierung") and no new bonds to this end will be issued. As a consequence, the stock-flow adjustment will be sizeable and the interest burden will gradually decrease, since the update assumes stable effective average interest rates (5.4%), which appears realistic.

Nominal GDP growth and the primary balance are forecast to contribute on average to an almost equal extent to the projected debt reduction. The contribution of economic growth is estimated to increase in 2004 and should remains fairly steady over the forecasting period, while the contribution of the primary balance fluctuates. Noteworthy - and not further commented upon in the update - is a sharp drop in the primary surplus by almost a full percentage point in 2003. An additional decline is projected for 2005, reflecting the revenue shortfalls relating to the tax reform. On average, the primary surplus should contribute by 2.3 percentage points annually to the projected debt reduction. Moreover, the stock-flow-adjustment increasingly contributes to the planned decline in the debt ratio, which appears to be line with the planned privatisations and reimbursement of bonds issued to finance state-owned enterprises, although respective estimates are not made explicit (see Table A-3 in annex).

5. SUSTAINABILITY OF PUBLIC FINANCES

Contrary to its previous version, the updated programme has a distinct long-term focus. Its backbone is a fundamental pension reform, envisaged to start in 2004 and to be phased in until 2009. The planned measures are listed in detail and are based to a large extent on the findings of the national expert group for pensions ("Pensionsreformkommission"), which were made public in December 2002. The main measures planned are well specified and will contribute considerably to the public pension system's long-term sustainability. The main shortcoming of the update is, however, that no estimates of the reform's budgetary impact

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13 Decision of Eurostat on deficit and debt, nr. 80/2002 of 3 July 2002: "Securitisation operations undertaken by general government"

are presented. Some goals, such as the increase in the participation rate – decisive for long-term calculations - are not further specified and it remains unclear how they will be achieved.

In the health sector, several fees shall be increased, financing of hospitals reformed, and profit margins for pharmaceutical products reviewed. Contrary to the government programme, announcing that several social security agencies also at the Länder level shall be merged, the update remains silent is this respect.

The updated stability programme contains a section on the sustainability of public finances. It includes national projections for public expenditures on pensions, health care and long term care, based on the demographic projections by the Austrian Statistical Office (STATAT). These show an overall increase in age-related spending of some 4 percentage points of GDP between 2005 and 2050, which is lower than the increase projected by the Economic Policy Committee.

It is first necessary to consider whether current budget polices can ensure that the SGP will continue to be respected in the future in light of the budgetary implications of ageing populations. The Commission considers that on the basis of current policies, the risk of emerging budget imbalances cannot be excluded.

A second issue is whether the budgetary strategy outlined in the programme is compatible with improving the sustainability of public finances. The approach outlined in the programme is mixed in this respect. On the one hand, the running of deficits over the time frame of the programme and the planned reduction in the primary surplus results is not in line with the need to ensure sustainable public finances. To ensure a faster pace of debt reduction, Austria should complete the transition to a budget position of 'close to balance or in surplus', in line with SGP requirements, without delay. On the other hand, the programme outlines planned reforms of the pension and health care system, which if adopted and implemented in full, could help constrain the growth in age-related public expenditures and thus make an important contribution to meeting the budgetary costs of ageing populations. These proposals, and in particular measures aimed at curtailing access to early-retirement schemes and raising employment rates amongst older workers, go in the right direction.

Finally, it is necessary to consider the type and scale of the budgetary challenges that will emerge in coming years to ensure sustainable public finances. First and foremost, a greater degree of urgency is required. Budgetary objectives need to be more ambitious: a medium-term target consisting of a deficit will not suffice: Austria needs to achieve a balanced budget position in underlying terms as soon as possible, and thereafter sustain sound public finance positions over the long run so that a significant fall in the debt ratio is recorded prior to the budgetary impact of ageing populations taking hold. At the same time, there is a need to proceed with the planned reform of pension and health care systems.

6. STRUCTURAL MEASURES AND OTHER REFORMS WITH LIKELY BUDGETARY IMPACT

Similarly to the previous programme but in more detail, the update outlines reform objectives for product, capital and labour markets geared towards improving Austria's attractiveness as a business location.

As to the labour market, the former system of severance payments, which hampered labour mobility, was transformed into an employee pension scheme, effective as of 2003. Claims accrue on individual accounts and, under certain conditions, may be paid out prematurely subject to income taxation. A preferential tax rate, however, applies if funds are disbursed after reaching the retirement age, which should be conducive to effectively build up the second pillar of the pension system.

Further reforms outlined in the update focus on raising the employment rate of older workers and on rendering the labour market more flexible. In particular, reforming the old-age part-time employment scheme (“Altersteilzeit”), which in its current functioning counteracts the legal increase in the retirement age, is of utmost importance. Moreover, modernising the legal framework governing working hours as well as modifying the acceptance criteria for jobs offered to the unemployed also seem appropriate.

The government intends to grant parents with young children the right to work part-time and to arrange flexible working-hours combined with the right to return into a full-time job once the child is aged 7. Moreover, as the employment rate of women shall be raised to 65% by 2010 from 60.1% in 2001, a speedy implementation of the government’s plans to provide adequate and sufficient childcare will prove crucial in this respect.

Regarding the capital market, the previous programme set out only one major reform, which was implemented as planned: In April 2002 the separate financial market supervisory bodies were merged into an independent public-law institution. In addition, in September 2002 nine concessions for newly established employee pension scheme were granted. According to the update, the government intends to strengthen the second and third pillar of the pension system and to foster venture capital formation, but concrete measures are not specified. Overall, despite some progress in the area of capital market reform, it remains highly likely that the main impediment for international investors, namely insufficient depth of the Austrian financial market, will persist.

With respect to product markets, the programme lists a series of privatisations which have either taken place from 2000 to 2002 or are planned for the current legislative period. Important issues for Austria, such as a low degree of competition in telecommunication or restrictive shop opening hours are addressed, the latter albeit with only marginal changes. According to the government’s plans and as announced the previous programme, the R&D ratio is to be increased, which is most appropriate in the light of Austria’s relatively low ranking in this area. The ambitious goal set in the government’s programme is to increase the R&D-to-GDP ratio almost 2% in 2002 to 2.5% by 2006 and to 3% by 2010. To this end, budgetary means for R&D ought to be increased substantially.

As regards environmental policies, the tax system, in the context of the envisaged reform, shall be modified as to encourage more environment-friendly behaviour of individuals and businesses. If, however, the planned rise in taxes on fossile energies is to serve that purpose rather than being just a tax increase, its ultimate end should be to reduce the tax base to zero and it should furthermore be complemented by adequate measures for renewable energies, with a view to adjust relative prices.

7. OVERALL ASSESSMENT OF COMPLIANCE WITH THE SGP

The updated Austrian stability programme is partly in line with the new code of conduct endorsed by the Council. After the collapse of the government in the beginning of September entailing parliamentary elections on 24 November 2002, the caretaker government decided not to present the update of the stability programme within the usual deadline at the beginning of December. The formation of a new government was delayed and it was sworn in three months after the election, on 28 February 2003. Roughly one month later, the Ministry of Finance transmitted the updated stability programme.

The structural budgetary position improved strongly in 2001. Correcting for the likely budgetary impact of the flood disaster, general government finances in 2002, although weakening markedly, could be considered close to balance. Yet, the budgetary path outlined in the update is only partly in line with the Stability and Growth Pact. In nominal terms, the deficit will reach a position close to balance only in 2007. The cyclically-adjusted deficit is expected to deviate markedly from balance in all years of the programme period, with the exception of 2004 and 2007. The deficit in structural terms is estimated to improve by the required “at least 0.5% of GDP” only in 2004 and 2007. Therefore, Austria would fully respect the requirements of the Stability and Growth Pact only in the last year the update’s horizon.

The safety margin seems sufficient, also in the low growth scenario, to prevent the deficit from to approaching the 3% of GDP benchmark throughout the programme period

Due to a substantial upward revision of general government debt, mainly due to a rectification of the Austrian gross debt reporting, the decline in the debt-to-GDP ratio is significantly delayed compared with the previous version of the programme. General government debt is forecast to decline throughout the programme period, dropping to below the 60% threshold by 2007.

ANNEX 1:
SUMMARY TABLES DERIVED FROM THE 2003 UPDATED STABILITY PROGRAMME

Table A-1: Growth and associated factors

	2001	2002	2003	2004	2005	2006	2007
GDP *growth* at *constant* market prices (7+8+9)	0.7	0.9	1.4	2.0	2.5	2.5	2.4
GDP *level* at *current* market prices	211.9	216.0	222.6	230.5	239.5	248.6	257.9
GDP deflator	1.8	1.1	1.6	1.5	1.4	1.3	1.4
HICP change	2.5	1.7	1.6	1.8	1.7	1.6	1.6
Employment growth	--	--	--	--	--	--	--
Dependent employment*	0.5	0.2	0.7	0.5	0.9	1.0	0.8
Labour productivity growth **	0.3	1.4	1.4	1.5	1.5	1.6	1.6
Sources of growth: percentage changes at constant prices							
1. Private consumption expenditure	1.5	0.6	0.9	1.6	2.0	1.8	1.4
2. Government consumption expenditure	-0.5	0.3	0.6	0.2	0.2	0.2	0.5
3. Gross fixed capital formation	-2.2	-2.3	1.5	2.6	3.7	3.9	3.6
4. Changes in inventories and net acquisition of valuables as a % of GDP	-0.4	0.0	-0.1	0.1	0.0	0.1	0.0
5. Exports of goods and services	7.4	0.8	3.4	4.7	5.6	5.4	5.3
6. Imports of goods and services	5.9	-1.1	2.6	4.2	5.0	4.8	4.7
Contribution to GDP growth							
7. Final domestic demand (1+2+3)	0.2	-0.1	1.0	1.5	2.0	1.9	1.7
8. Change in inventories and net acquisition of valuables (=4)	-0.4	0.0	-0.1	0.1	0.0	0.1	0.0
9. External balance of goods and services (5-6)	0.8	1.0	0.5	0.4	0.5	0.5	0.6
Basic assumptions							
Short-term interest rate (annual average)	4.3	3.0	2.5	2.5	3.0	3.0	3.0
Long-term interest rate (annual average)	5.1	5.1	5.0	5.3	5.4	5.4	5.4
USD/€ exchange rate (annual average)	0.896	0.945	1.058	1.058	1.058	1.058	1.058
(for non-euro countries) exchange rate vis-à-vis the € (annual average)	--	--	--	--	--	--	--
World excluding EU,GDP growth	--	--	--	--	--	--	--
EU-15 GDP growth	--	--	--	--	--	--	--
Growth of relevant foreign markets	--	--	--	--	--	--	--
World import volumes, excluding EU	--	--	--	--	--	--	--
Oil prices	24.6	25.5	30.1	22.0	22.4	22.9	23.3

* According to social security statistics, i.e. including persons on parental leave

** calculated on basis of effective labour force

Table A-2. General government budgetary developments

% of GDP	2001	2002	2003	2004	2005	2006	2007
Net lending by sub-sectors							
1. General government	0.3	-0.6	-1.3	-0.7	-1.5	-1.1	-0.4
2. Central government	-0.5	-1.0	-1.8	-1.4	-2.2	-1.9	-1.1
3. State government	0.5	0.4	0.4	0.7	0.75	0.75	0.75
4. Local government	0.1	0.1	0.1	0.0	0.0	0.0	0.0
5. Social security funds	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0
General government							
6. Total receipts	52.3	51.5	51.1	50.8	49.5	49.4	49.4
7. Total expenditures	52.0	52.1	52.4	51.6	51.0	50.5	49.8
8. Budget balance	0.3	-0.6	-1.3	-0.7	-1.5	-1.1	-0.4
9. Net interest payments	3.8	3.7	3.6	3.5	3.4	3.3	3.2
10. Primary balance	4.1	3.2	2.3	2.7	1.9	2.2	2.8
Components of revenues							
11. Taxes	29.8	28.9	28.5	28.5	27.2	27.2	27.2
12. Social contributions	17.0	17.2	17.1	16.9	16.9	16.9	16.9
13. Interest income	5.5	5.5	5.5	5.5	5.4	5.3	5.2
14. Other	5.5	5.5	5.5	5.5	5.4	5.3	5.2
15. Total receipts	52.3	51.5	51.1	50.8	49.5	49.4	49.4
Components of expenditures							
16. Collective consumption	7.6	7.7	7.6	7.5	7.4	7.3	7.2
17. Social transfers in kind	11.6	11.7	11.6	11.4	11.2	11.1	10.9
18. Social transfers other than in kind	18.6	18.9	19.2	19.1	18.9	18.8	18.6
19. Interest payments	3.8	3.7	3.6	3.5	3.4	3.3	3.2
20. Subsidies	2.6	2.7	2.7	2.8	2.9	2.9	2.8
21. Gross fixed capital formation	1.2	1.1	1.1	1.0	1.0	1.0	1.0
22. Other	6.7	6.3	6.6	6.3	6.3	6.2	6.1
23. Total expenditures	52.0	52.1	52.4	51.6	51.0	50.5	49.8

Table A-3. General government debt developments

% of GDP	2001	2002	2003	2004	2005	2006	2007
Gross debt level	67.3	67.8	67.0	65.1	63.8	62.1	59.7
Change in gross debt	2.5	0.5	-0.8	-1.9	-1.3	-1.7	-2.4
Contributions to change in gross debt							
Primary balance	-4.1	-3.2	-2.3	-2.7	-1.9	-2.2	-2.8
Interest payments	3.8	3.7	3.6	3.5	3.4	3.3	3.2
Nominal GDP growth	-1.6	-1.3	-2.0	-2.3	-2.4	-2.3	-2.3
Other factors influencing the debt ratio	--	--	--	--	--	--	--
Of which: Privatisation receipts	--	--	--	--	--	--	--
p.m. implicit interest rate on debt	5.8	5.6	5.5	5.4	5.4	5.4	5.4

Table A-4. Cyclical developments

% of GDP		2002	2003	2004	2005	2006	2007
1. GDP growth at constant prices		0.9	1.4	2.0	2.5	2.5	2.4
2. Actual balance*		-0.6	-1.3	-0.7	-1.5	-1.1	-0.4
3. Interest payments		3.7	3.6	3.5	3.3	3.3	3.2
4. Potential GDP growth **		2.0	2.0	2.0	2.0	2.0	2.0
5. Output gap		-0.3	-1.0	-1.0	-0.6	-0.1	0.3
6. Cyclical budgetary component*		-0.1	-0.3	-0.3	-0.2	0.0	0.1
7. Cyclically-adjusted balance (2-6)		-0.4	-0.9	-0.4	-1.3	-1.1	-0.5
8. Cyclically-adjusted primary balance (7-3)		3.3	2.7	3.2	2.0	2.1	2.6

*including tax reform and SWAP-operations
**HP-filter method
NB: Rounding differences are possible. The cyclically-adjusted budget balance may vary by ± ¼ percent of GDP.
Sources: Statistik Austria; Federal Ministry of Finance.

Table A-5. Divergence from previous update

% of GDP	2002	2003	2004	2005	2006	2007
GDP growth						
previous update	1.3	2.4	2.8	2.8	-	-
latest update	0.9	1.4	2.0	2.5	2.5	2.4
Difference	-0.4	-1.0	-0.8	-0.3	-	-
Actual budget balance						
previous update	0.0	0.0	0.2	0.5	-	-
latest update*	-0.6	-1.3	-0.7	-1.5	-1.1	-0.4
Difference**	-0.6	-1.3	-0.9	-2.0	-	-
Gross debt levels						
previous update	59.6	57.2	54.7	52.1	-	-
latest update	67.8	67.0	65.1	63.8	62.1	59.7
Difference***	8.2	9.8	10.4	11.7	-	-

* including tax reform and SWAP-Operations
** a positive sign denotes an improvement
*** a positive sign denotes a deterioration

Table A-6. Long-term sustainability of public finances

% of GDP	**2005**	**2010**	**2020**	**2030**	**2050**
Total expenditure	51	--	--	--	--
Old age pensions	14.7	14.9	15.8	17.2	16.5
Health care (including care for the elderly)	5.1	5.2	5.6	6.0	6.4
Interest payments	3.4	--	--	--	--
Total revenues	49.5	--	--	--	--
of which: from pensions contributions	--	--	--	--	--
National pension fund assets (if any)	**--**	**--**	**--**	**--**	**--**
Assumptions					
Labour productivity growth	2.0	1.9	1.8	1 ¾	1 ¾
Real GDP growth	2.3	2.3	1.6	1.4	1.6
Participation rate males (aged 20-64)*	76.7	76.5	77.0	78.7	81.2
Participation rates females (aged 20-64)*	60.8	61.7	61.7	64.7	70.1
Total participation rates (aged 20-64)*	68.8	69.2	69.4	71.8	75.8
Unemployment rate	3.7	3.0	3.0	3.0	3.0

* (Age 15-64)

Table A-7. Basic assumptions from the Commission's 2003 spring forecast

		2001	2002	2003	2004
Basic assumptions					
Short-term interest rate (annual average)		4.3	3.3	2.4	2.7
Long-term interest rate (annual average)		5.1	5.0	4.1	4.7
USD/€ exchange rate (annual average)		0.90	0.94	1.07	1.06
(for non-euro countries) exchange rate vis-à-vis the € (annual average)		--	--	--	--
World excluding EU,GDP growth		2.4	3.2	3.6	4.0
EU-15 GDP growth		1.6	1.1	1.3	2.4
Growth of relevant foreign markets		1.1	3.4	5.0	7.0
World import volumes, excluding EU		-1.2	4.1	6.4	7.1
Oil prices		25.0	25.0	27.6	23.5

ANNEX 2: QUANTITATIVE ASSESSMENT OF THE SUSTAINABILITY OF PUBLIC FINANCES

This is the second assessment of the sustainability of Austrian public finances as part of the Stability and Growth Pact. The quantitative indicators are similar to those used last year, but have been adjusted in line with the recommendations of the Ageing Working Group to the EPC.[14]

The Austrian stability programme contains a section assessing the sustainability of public finances and includes national budgetary projections for public expenditures on pensions, health care, and long term care. It differs from the EPC projections in that it is based on a demographic projection of the Austrian National Statistical Institute. According to the stability programme, the EPC assumptions regarding labour force participation rates and productivity growth are taken on board, and the projections do not incorporate the planned reforms to the pension system planned for 2004.

The Austrian projection indicate that age-related spending by 2040 will increase by 1.8 percentage points of GDP less than what was projected by the EPC. Of this difference, 1 percentage point relates to public spending on pensions and 0.7 percentage points to lower spending on health care. In assessing the sustainability of public finances, the Commission has to draw a balance between using national projections which may be more comprehensive and up to data, and the need to ensure comparability across countries. The Commission ran the sustainability indicators using the projections for pensions included in the stability programme. As a result, the indicators on the sustainability of public finances show a more positive outcome than would have emerged had the EPC projections been used, and consequently further analysis of the difference in both sets of projections is warranted.

The table below presents the debt and budget balance developments according to two different scenarios, a “programme scenario” and a “2002 situation scenario”. The ”programme scenario” is calculated on the following basis:

- the projections for age-related expenditures come from the stability programme;
- government revenues are held constant at the ratio projected for 2006;
- the starting point for gross debt and the primary surplus are the 2006 levels reported in the programme.

The “2002 situation scenario” is based on the budgetary data for 2002 in the programme. It is that no budgetary adjustment occurs during the time frame of the stability programme: in other words the primary balance remains unchanged at its 2002 level until 2006. This allow one to gauge the impact on the sustainability of public finances of the proposed change in the underlying budget position during the programme. The risk of unsustainable public finances, measured in terms of continued compliance with SGP requirements, is apparent under both scenarios.).

[14] ‘How the sustainability of public finances was assessed using the 2001 updates of stability and convergence programmes: recommendations for improvements in future years’, Note from the AWG to the EPC, EPC/ECFIN/396-02 of 23 July 2002.

Quantitative indicators on the sustainability of public finances

Main assumptions - baseline scenario (as % GDP)	2006	2010	2020	2030	2040	2050	changes
Total age-related spending	20,6	20,9	22,4	24,3	24,9	24,4	3,8
Pensions	14,7	14,9	15,8	17,2	17,3	16,5	1,8
Health care	5,1	5,2	5,6	6,0	6,3	6,4	1,3
Other age related expenditures	0,7	0,8	1,0	1,1	1,3	1,5	0,8
*Total non age-related spending**	27,1						
*Total revenues**	49,4						

* constant

Results (as % GDP)	2006	2010	2020	2030	2040	2050	changes
Programme scenario							
Debt	62,1	59,4	64,1	87,8	130,9	184,8	122,7
Net borrowing	-1,1	-1,9	-3,5	-6,6	-9,5	-12,0	-10,9
2002 situation scenario							
Debt	60,6	51,7	38,6	41,5	58,5	80,0	19,4
Net borrowing	-0,1	-0,1	-0,7	-2,7	-4,2	-4,9	-4,8

Tax gaps	T1*	T2**	T3***
Programme scenario	2,6	2,1	3,4
2002 situation scenario	1,0	0,6	1,9

* it expresses the constant difference between projected revenues and the revenues required to reach in 2050 the same debt to GDP ratio as the close to balance position holds for the whole projection period. P.m. debt to GDP at the end of the period: 12.1

** it expresses the constant difference between projected revenues and the revenues required to reach in 2050 a debt to GDP ratio equals to 40%.

*** It indicates the change in tax revenues as a share of GDP that guarantees the respect of the interteporal budget constraint of the government, i.e., that equates the actualized flow of revenues and expenses over an infinite horizon.

Source: EPC, and 2002 Updated stability programme of Austria . Commission calculations