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2004 UPDATE OF THE STABILITY PROGRAMME FOR AUSTRIA (2003-2007)

AN ASSESSMENT

Table of Contents

Tables

SUMMARY AND CONCLUSION*

The stability programme update broadly complies with the revised "code of conduct on the content and format of stability and converge programmes". In terms of content most measures are described in sufficient detail. However, with respect to presentational weaknesses of the previous programme little improvement has been made. Specifically, measures contained in the twin budget 2003/2004 are known in detail and it would have been both desirable and feasible to include concrete estimates of their budgetary effects. Furthermore, the alternative growth scenarios presented in the update use implicit budget elasticities that vary over the years, an economically unlikely assumption, and across scenarios. Although pointed out in the last assessment, the estimation techniques have not sufficiently changed.

The budgetary projections of the programme are based on a macro-economic scenario expecting economic activity to resume from its current cyclical weakness. The real GDP growth projections until 2005 are equivalent to the Commission services' autumns 2003 forecast, while nominal GDP growth and employment expectations in the update are significantly higher. By and large, the macro-economic scenario in the update appears plausible, although leaning towards the optimistic side. Specifically, the acceleration in employment growth to 0.6% (ESA95 definition) in 2004 appears brisk, given the usual time-lag of labour demand to a cyclical upturn of activity. Although real GDP growth in 2006 and 2007 would remain above potential, the implicit closing of the output gap after a period of sluggish growth would not seem implausible, due to the positive impact of recent and ongoing structural reforms and enlargement, given that macroeconomic imbalances are absent in the Austrian economy.

The updated stability programme maintains the budgetary targets of the previous programme. Deficits are projected over the entire programme period, which in three out of five years are set to exceed 1% of GDP, averaging 1.0% of GDP throughout the projection period 2003-2007. The deficit forecasts are based on an unchanged budgetary strategy, envisaging substantial structural savings combined with sizeable tax cuts aiming at reducing the tax burden from its peak of 45.4% in 2001 to 43% of GDP by 2006.

For 2002, budgetary and national accounts data have been significantly revised. General government finances weakened but remained close to balance contrary to previous figures indicating a substantial widening of the deficit. From a surplus of 0.3% of GDP in 2001, the budgetary position deteriorated to a small deficit of 0.1% of GDP (revised up from 0.6%). Three factors account for this downward revision by 0.5 percentage point: a national accounts data release revising real GDP growth in 2002 significantly upwards, statistical factors and higher surpluses at lower levels of government. The cyclically-adjusted balance, calculated by the Commission, deteriorated by 0.4 percentage point to -0.1% of GDP.

In 2003, the update projects the general government deficit to widen considerably to 1.3% in 2003. In cyclically-adjusted terms, this corresponds to an increase in the deficit by 0.8 percentage point, up from a 0.5 percentage point rise in the previous programme. While the smaller deterioration projected in the previous programme could be attributed to the budgetary effects of the flood disaster in summer 2002, more recent estimates revise the flood-related impact on the budget 2003 down by almost 0.3 percentage point. Against this background, it would appear reasonable to expect a better budgetary outcome in cyclically-adjusted terms, yet the update projects a considerably larger increase without putting forward explanations. The Commission services projected in their autumn 2003 forecast a better-

* This assessment has been carried out on the basis of information available as of 22.12.2003.

than-targeted deficit of 1% of GDP, which could turn out even lower in the light of the available data by the end of November. After a temporary decline in 2004, the deficit is set to widen markedly to 1.5% in 2005 owing to sizeable income tax cuts. Although narrowing thereafter, the government finances reaches a position close to balance only in 2007, when the cyclically-adjusted deficit falls by the required ½ percentage point to a 0.5% of GDP.

Given the observed relatively low elasticity of the budget balance to the economic cycle in Austria, the projected path of government finances would leave sufficient safety margin to prevent the deficit from breaching the 3% of GDP reference value in the event of a normal cyclical downturn. Downside macroeconomic risks seem to balance with the likelihood of a better-than-targeted budgetary outcome in 2003 with knock-on effects on subsequent years. However, the deficit forecasts hinge crucially on the successful implementation of the planned savings measures. Therefore, an asymmetric implementation of the expenditure and revenue side measures represents the main risk to the government's strategy. If the planned savings would materialize only partially and the tax relief were fully implemented, Austria would not have sufficient budgetary leeway in 2005 to let the automatic stabilisers work fully in the event of a normal cyclical downturn.

Figures for gross government debt were significantly revised upwards in 2001 and 2002 and ratcheted up to 66.7% of GDP in 2002. Consequently, the decline in the debt-to-GDP ratio, expected to fall marginally below the 60% reference value in 2007, is significantly delayed. This forecast hinges crucially on optimistic nominal GDP growth assumptions and in particular on sizable proceeds from planned privatisations. Should any of these factors fall short of expectations, even if only by a small margin, the debt-to-GDP-ratio would remain above the 60% reference value also in 2007. Likewise, in a scenario where the deficit in 2003 turns out lower than officially forecast, at or somewhat below 1.0% of GDP, general government debt would also remain above 60% in the event of slightly lower growth.

The strategy involves a sizeable income tax relief, totalling 1.3% of GDP, will not be compensated by commensurate spending cuts. Past experience has shown that cutting taxes without ensuring commensurate expenditure restraint is a risky strategy. Problematic is the second phase of tax relief in 2005, projected to increase the cyclically-adjusted deficit markedly by a full percentage point. While in principle a sizeable reduction of the high overall tax burden would be welcome, more decisive expenditure cuts would be appropriate, in order to prevent the deficit from widening. The forecast cyclical upswing, projecting the Austrian economy to expand at a rate above potential by 2005 with a closing output gap, confirms the need for additional expenditure restraint, which would be the most appropriate method to prevent pro-cyclical effects. Moreover, although the tax reform should improve supply-side conditions for growth, the 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.

Concerning the medium-term objective, it is only in 2004 and in 2007 that 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. Moreover, under more realistic nominal GDP growth assumptions, there is a strong likelihood that the general government debt, although declining in all years of the projection period, remains above the 60% of GDP benchmark even in 2007.

As regards recent policy developments, the most remarkable event is the comprehensive overhaul of the pension system, adopted in June 2003. The measures should enhance the actuarial fairness of the pay-as-you-go scheme and raise the effective retirement age as well as the labour force participation of older workers.

Incorporating the impact of the 2003 pension reform, the Commission considers with regard to long-term sustainability that Austria appears to be in a relatively good position to meet the budgetary costs associated with ageing populations. The budgetary strategy outlined in the programme is compatible with improving the sustainability of public finances. According to the Commission assessment, debt-to-GDP ratios will remain below 60%, once attained also in the long run if age-related expenditures will develop as expected. The 2003 pension reform should correct pension expenditure trends and reduce the peak by around 1.5% of GDP compared with previous projections. However, projected results warrant attention. First, the 10%-cap on reform-related pension benefit losses until 2032 increases uncertainty on real savings in the next 30 years. Second, results rely strongly on the assumed increase of participation rates among older workers induced by the pension reform. Since the updated programme's strategy is mainly based on the implementation of the pension reform and on its impact on labour market behaviours, a strict monitoring of pension expenditure trends and a more transparent knowledge of those factors behind the foreseen savings is crucial. Therefore, some aspects of the pension reform, such as the 10%-cap and an excessively long transition period for abolishing early retirement need to be reviewed, to render long-term prospects more certain.

Economic policies as reflected in the update are only in part consistent with the recommendations in the Broad Economic Policy Guidelines. Specifically, "a cyclically-adjusted budgetary position close to balance" is only partly respected. Moreover, in 2005 the general guideline to "avoid pro-cyclical policies" is not observed. Although the planned reduction of the high tax burden is in principle an appropriate step to render supply side conditions more growth-friendly, revenue reductions should be accompanied by corresponding expenditure restraint. As concerns *Länder* and communities, the update is silent on "structural expenditure savings, (also) at lower levels of government", which are required to attain permanent surpluses, an obligation enshrined in a national stability pact.

1. INTRODUCTION

The Austrian Council of Ministers adopted the update of the Austrian stability programme on 18 November 2003. The update covers the period up to 2007, unchanged from the previous version of the programme. This is the fifth annual update of the stability 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[1].

The previous programme was assessed by the Commission and the Economic and Financial Committee. The Council gave its opinionon 13 May 2003[2].

The budgetary targets of the updated stability programme remain unchanged, based on, with the exception of 2003, equivalent growth forecasts. The update continues to concentrate on long-term issues, envisaging structural changes in the health care sector, after a comprehensive reform of public pensions was adopted in June 2003. In addition, a substantial tax relief is announced, intended to reduce the high tax burden and to be introduced in two steps beginning in 2004. However, maintaining a close-to-balance budgetary position beyond 2002 is not an objective within the planning horizon.

Indeed, the update, as its predecessor, projects the general government financial position to deteriorate, both in nominal and in cyclically-adjusted terms. The general government deficit

1 The programme has been made available on the internet page of the Austrian Ministry of Finance http://www.bmf.gv.at/service/publikationen/download/berichte/stab03-07_2.pdf (German original) and http://www.bmf.gv.at/ministerium/ministerium/englisch/pub/st2007en_neu.pdf (English translation)

2 OJ C 123/1, 24.5.2003

will remain on average at 1% of GDP throughout the projection period 2003-07, although the Council encouraged the Austrian government to return faster than foreseen to budgetary balance.

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. THE MACROECONOMIC SCENARIO

2.1 External economic assumptions

The programme's external assumptions and those used in the Commission's autumn forecast are alike. Assumptions for world import volumes (excl. EU) and growth of relevant foreign markets, however, are not made explicit.

2.2 Macroeconomic developments

Although Austria lives through its third year of sluggish growth, it has withstood the international slowdown better than other European countries. According to the latest national accounts data release of October 2003, real GDP growth for 2002 was revised upwards by half a percentage point to 1.4%. Thus, rather than expanding at the same subdued rate as in the year before, output growth accelerated by a noticeable, given the international circumstances, 0.6 percentage point after a cyclical trough in 2001 (real GDP growth in 2001 was also revised upwards by 0.1 p.p. to 0.8%). As a consequence, the output gap closed instead of turning negative. While foreign trade with Germany, accounting for more than a third of Austria's exports, rose at a slow pace, trade with the east has flourished. Moreover, public sector infrastructure spending boosted construction in particular, a large sector because of a long tradition of residential housing grants.

- *Comparison with Commission Autumn 2003 Forecast*

In 2003, output growth in the updated programme is projected to slow down to 0.9% in 2003 and to pick up to 1.9% in 2004, with the international upswing gaining momentum and domestic demand strengthening to an extent to become a mainstay of growth. Projected to accelerate further to 2.5% in 2005, output is expected to expand at a similar rate in the two final years of the programme. This is equivalent to the previous version of the programme, with the exception of a noticeable downward revision for 2003 by half a percentage point and 0.1 p.p. for 2004.

By and large, the macroeconomic scenario up to 2005 sketched in the updated stability programme resembles the Commission services' autumn forecast. The projections for real GDP growth for 2005 are coinciding and are close for most other variables. However, considerable differences concern employment growth in 2004 and 2005 and the GDP deflator in 2005. Moreover, underlying the identical projections for GDP growth in 2005 are different projections for the fiscal stance, with a budget deficit of 0.2% of GDP in the Commission forecast (based upon the no-policy-change assumption) and a deficit ratio of 1.5% in the programme update.

In the updated programme, the Austrian employment growth projections include persons on parental leave. This does not correspond to the ESA95 definition and does not correctly reflect the underlying labour market developments. Labour productivity calculations by contrast, were based on economically active employment as required by the ESA95 definition, also used to calculate social contributions for the budgetary outlook. Clearly, in

terms of transparency, it would be desirable if the economic assumptions presented on employment growth did not diverge from those actually used for the budgetary calculations.

In order to render forecasts comparable, the Commission services calculated the implicit employment growth projection in ESA95 definition, derived from the update's labour productivity growth assumptions (included in the table below). The results show that the Austrian authorities expect a brisk expansion of dependent employment, rising markedly by 0.6% in 2004 and 0.9% in 2005, while the Commission services forecast slower employment growth of 0.3% and 0.5% respectively. Given the usual reaction lag in the labour market, the Commission services expect a more sustained pick-up in labour demand only late in 2004, when economic activity should have gained momentum. Given elastic labour supply, the rebound in growth should not translate immediately into falling unemployment, after the sharp rise in 2003, as expected by the update. Against the background of similar assumptions about cyclical developments, the update's employment and to some extent also the unemployment assumptions appear optimistic.

Table 1: Macroeconomic scenario – forecast comparison

Economic Forecasts 2002-2005
(Annual average growth rate, in %)

	2002	2003		2004		2005	
	National Accounts	**Stability Prog.** 1)	**ECFIN Autumn** 2)	**Stability Prog.** 1)	**ECFIN Autumn** 2)	**Stability Prog.** 1)	**ECFIN Autumn** 2)
GDP	1.4	0.9	0.9	1.9	1.9	2.5	2.5
Private consumption	0.8	1.4	1.1	2.0	1.8	2.0	2.2
Exports (Goods & Services)	3.7	-0.2	1.1	2.9	5.7	5.6	7.6
Imports (Goods & Services)	1.2	0.5	1.1	2.8	5.7	5.0	7.6
GDP deflator	1.4	1.4	1.3	1.3	1.2	1.5	1.1
HICP	1.7	1.3	1.3	1.2	1.2	1.5	1.1
Employment growth a)	0.2	0.2	0.1	0.5	0.3	0.9	0.5
Employment growth b)	0.2	0.1	0.1	0.6	0.3	0.9	0.5
Unemployment c)	4.3	4.5	4.5	4.4	4.6	4.1	4.1
Budget balance (% of GDP)	**-0.2**	**-1.3**	**-1.0**	**-0.7**	**-0.6**	**-1.5**	**-0.2***
Debt (% of GDP)	**66.7**	**66.4**	**66.4**	**65.8**	**65.2**	**64.1**	**63.2**

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) Commission services' calculation: implicit rate for effective dependent employment, ESA 95 definition, derived from labour productivity growth, i.e. on basis of effective labour force (=ESA95)

c) % of labour force

* excluding the planned tax relief of some 1% of GDP due to the customary no-policy-change assumption

1) November 2003 2) October 2003

Nominal GDP growth in 2005 is higher in the update than in the Commission services' autumn forecast. The difference of 0.4 percentage point is entirely due to the GDP deflator, which is slightly above the Commission estimate also in 2003 and 2004. On the one hand, it could be argued that the expected increase in the deflator by 0.2 percentage point to 1.5% in 2005 would be line with wage as well as profit margin increases expected to accelerate in an environment of strong pick-up in growth. On the other hand, the projected trend of the GDP deflator could hint at substantial terms of trade gains which would, however, be at variance

with the projected widening of the current account deficit, despite a positive real trade and services balance.

Last but not least, for 2004 the inflation forecasts of the stability programme and the Commission services diverge, while they coincide for 2003 (1.3%) and 2005 (1.5%). In particular the trajectory expected in the programme is at odds with tax increases starting as of January 2004. The update expects HICP to decline slightly to 1.2% in 2004 and to increase in 2005. The Commission services, by contrast, assume inflation in 2004 to accelerate temporarily to 1.6% owing to the rise in energy taxes and excise duties on tobacco starting in January.

- *Output Gap, potential output growth and return to potential*

The estimates for potential output growth (HP trend growth[3]) and the output gap of the updated stability programme up to 2007 closely resemble the Commission services estimates. For both variables divergences, if any, are never larger than ±0.1 percentage point.

Based on the analysis of potential growth it could be argued that the medium-term growth outlook for 2006 and 2007 is on the high side, at least when postulating some safety margin for the baseline budgetary scenario.

In 2006 and 2007, projected real GDP growth continues to outpace estimated potential output by ½ percentage point, as in 2005. Thus, the average annual growth rate for the period 2003 to 2007 projected in the update is slightly above 2%, which is close to average potential output growth of 1.9% as estimated by the Commission. Nevertheless, real GDP growth rates of 2½% as of 2005 may not be out of reach.

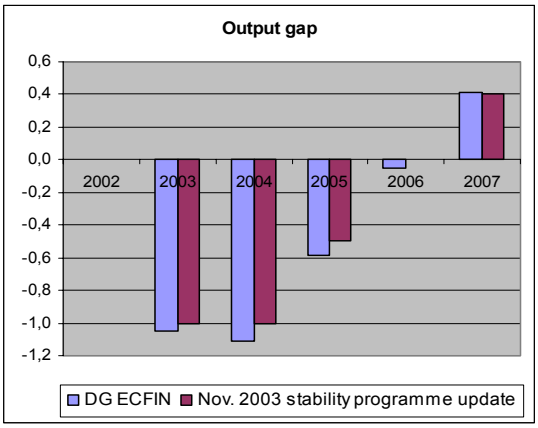

*Table 2: Real GDP growth, potential real GDP growth and output gap calculated applying the agreed HP filter method**

	2002	2003	2004	2005	2006	2007
Commission Autumn forecast						
Real GDP growth (%)	1.4	0.9	1.9	2.5	-	-
Potential real GDP growth (%)	2.0	1.9	1.9	1.9	-	-
Output gap	0.1	-0.8	-0.8	-0.3	-	-
Stability programme 2004 update						
Real GDP growth (%)	1.4	0.9	1.9	2.5	2.5	2.4
Potential real GDP growth (%)	1.9	1.9	1.9	2.0	2.0	2.0
Output gap	0.0	-1.0	-1.0	-0.5	0.0	0.4
Output gap based on potential growth (HP trend*) by Commission services	0.0	-1.0	-1.1	-0.6	0.0	0.4

** Austria has been granted a derogation to the commonly agreed production function method*

[3] According to a derogation granted to Austria, trend growth continues to be calculated by the HP-filter and not by the Commission's production function method.

The favourable medium-term outlook for the Austrian economy could be justified for the following reasons. First, no important imbalances in the economy are to be expected. In particular, social partners are likely to continue their policy of setting wages in line with maintaining international competitiveness. In the last some 15 years, Austria has achieved a considerable cost advantage vis-à-vis its important trading partners through a mixture of wage moderation and gains in productivity[4]. Second, according to various studies EU-enlargement is expected to provide a significant fillip to the Austrian economy. Trade with eastern European countries has helped Austria to weather the current global downturn relatively well. A decisive and possibly limiting factor, however, is a less favourable growth performance of Austria's main trading partners than currently forecast.

All in all, the macro-economic scenario presented in the update appears plausible . After a period of sluggish growth, the output gap may indeed close and eventually turn positive, to the extent that the ongoing and planned structural reforms are expected to raise employment and growth and thereby boost consumer and business confidence.

3. BUDGETARY TARGETS AND MEDIUM TERM PATH OF PUBLIC FINANCES

3.1 Programme overview

The budgetary targets remain unchanged for all years, even for 2003, although a better outcome could reasonably be expected. The updated programme projects the deficit to widen significantly by more than one percentage point from 0.1% in 2002 to 1.3% of GDP in 2003, with lower output growth accounting for only a fraction of the expected deterioration. After a temporary decline 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.

Table 3: GDP growth and general government balance: The March 2003 and the November 2003 programmes compared

	%	2002	2003	2004	2005	2006	2007
Real GDP growth	**November 2003**	1.4	0.9	1.9	2.5	2.5	2.4
	March 2003	0.9	1.4	2.0	2.5	2.5	2.4
	Difference	*0.5*	*-0.5*	*-0.1*	*0.0*	*0.0*	*0.0*
Net lending/borrowing	**November 2003**	-0.1	-1.3	-0.7	-1.5	-1.1	-0.4
% of GDP	**March 2003**	-0.6	-1.3	-0.7	-1.5	-1.1	-0.4
	Difference	*0.5*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*
Source: updated stability programmes of March 2003 and Nov. 2003							

The budgetary strategy, as well, remains unchanged, with a distinct long-term focus. On the expenditure side, savings are to be generated by recent and ongoing reforms. Specifically, in a next phase individual retirement accounts shall be established and pension systems for different occupational categories fully harmonised. Moreover, further savings should result from the continued reduction in the number of civil servants, streamlining subsidies, restructuring the federal railways, disentangling responsibilities between different levels of government, and the planned reform of the health care system.

[4] Data on relative unit labour costs

In addition, the government intends to reform the health insurance system but important structural changes should enter into force only by 2005 "at the earliest". Moreover, the update does not mention a key element of the health care reform, despite presenting a detailed list of planned measures. That is the merger of sickness funds, which was explicitly announced in the government programme and emphasised in subsequent policy debates. Streamlining the currently split up health insurance funds could, however, prove central to attain the targeted savings.

On the revenue side, a sizeable tax relief is in the offing, envisaged to cost € 3 billion or 1.3% of GDP. It is intended to reduce the tax burden from its peak of 45.4% in 2001 to below 43% of GDP by the year 2006. The first and smaller step will take effect as of January 2004 and the blueprint for its second phase is being prepared, to be presented in February 2004 according to government's plans.

In line with the comment made on the previous version of the programme, in quantitative terms**,** more information would have been appreciated. Therefore, as a general feature of the updated programme, quantitative indications regarding particular measures represent political objectives or spending/revenue targets. It would have been desirable, however, to present detailed estimates of their budgetary impact, given that some of the most significant measures were adopted with the twin budget 2003/2004, passed in June 2003.

The updated stability programme expects total revenues to increase on average by 2.1% annually over the period 2003-07, which is almost 1½ percentage point below the projected average nominal GDP growth of 3.5%. As a consequence, the revenue-to-GDP ratio is expected to drop by 3.2 percentage points from 2002 to 48% in 2007 (see

Table *4*). The burden of taxes and social charges is forecast to fall by 2.1 percentage points from 2002 to 43.4% of GDP in 2007 due to the tax reform. Total expenditure is estimated to rise at virtually the same pace as total revenue, by 2.2% 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 2.9% percentage points from 2002 to 48.4% in 2007.

Table 4: Revenue and expenditure projections

	in % of GDP	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Update 11/2003	**Total revenues**	**52.0**	**51.2**	**50.6**	**50.0**	**48.5**	**48.3**	**48.0**
	Of which: Tax and social charges [1)]	46.4	45.5	45.3	44.8	43.6	43.6	43.4
	Total expenditure	**51.8**	**51.3**	**51.9**	**50.7**	**50.0**	**49.4**	**48.4**
	Of which: Primary expenditure[2)]	48.1	47.7	48.3	47.2	46.6	46.1	45.2
03/2003 (*)	**Total revenues**	**52.3**	**51.5**	**51.1**	**50.8**	**49.5**	**49.4**	**49.4**
	Of which: Tax and social charges [1)]	46.8	46.1	45.6	45.4	44.1	44.1	44.1
	Total expenditure	**52.0**	**52.1**	**52.4**	**51.6**	**51.0**	**50.5**	**49.8**
	Of which: 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 November 2003 programme
Source: Austrian stability programmes (March 2003 and Nov. 2003), Commission services.

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 regional governments, the *Bundesländer* committed themselves to run annual budget surpluses of on average 0.75% of GDP. Although these targets are binding and meeting them should be ensured by the internal stability pact, this

obligation is temporarily suspended as far as flood-related expenditure in 2002 and 2003 is concerned. Until 2004, *Länder* could in principle make up for any under-performance, if need be. However, recent data revisions for 2001 and 2002 in combination with the forecasts for 2003 and 2004 indicate an annual average surplus of some 0.7% of GDP, close to the initial objective.

The Austrian *Finanzausgleich* will expire at the end of 2004. Designing a compromise on a subsequent revenue sharing arrangement is a difficult task, being a matter of power between the federal and lower levels of government. The so-called Austrian Convention[5], a major undertaking to prepare a constitutional reform, is vital for redefining the role of the state und thus dismantling responsibilities. According to the updated stability programme, the obligation of annual surpluses of ¾% of GDP should be extended. Therefore, expenditure savings have to be stepped up significantly at the regional and local level in order to permanently achieve these surpluses. However, the update remains silent on plans concerning lower levels of government.

The programme presents cyclically-adjusted budget balances (CAB) which are similar to those obtained by the Commission method applied to the updated programme's projections. Compared with the calculations presented in the Commission services' autumn forecast, the differences are explained by different assumptions on the nominal budgetary outcome. It should be noted that the planned tax relief 2005 is not incorporated in the Commission forecast due to the customary no-policy change assumption (see **Table 5**).

The deficit path projected in the update, confirmed by DG ECFIN's method, indicates that Austria starts moving away from budget balance as of 2003 and, with the exception of 2004, will not return to a close-to-balance position before 2007. 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 in cyclically-adjusted terms is projected at or below 0.5% of GDP.

Table 5: Cyclically adjusted public finances (CAB)

	Stability Programme					Autumn Forecast			
	Budget balance	GDP growth	HP Trend growth	CAB	CAB Ecfin method	Budget Balance	GDP Growth	HP Trend growth	CAB
	% of GDP	% change	% change	% of GDP	% of GDP	% of GDP	% change	% change	% of GDP
2002	-0.1	1.4	1.9	-0.2	-0.1	-0.2	1.4	2.0	-0.2
2003	-1.3	0.9	1.9	-1.0	-1.0	-1.0	0.9	1.9	-0.7
2004	-0.7	1.9	1.9	-0.4	-0.4	-0.6	1.9	1.9	-0.3
2005	-1.5	2.5	2.0	-1.3	-1.4	-0.2*	2.5	1.9	-0.1*
2006	-1.1	2.5	2.0	-1.1	-1.1	--	--	--	--
2007	-0.4	2.4	2.0	-0.5	-0.5	--	--	--	--

* Due to the no-policy change assumptions the planned tax relief is not incorporated in the autumn forecast
Source: Stability programme November 2003, Commission services' autumn forecast 2003

[5] Austrian Convention: A high-level expert groups set up for the purpose of reforming the Austrian Constitution and redefining responsibilities for the different government levels. Its report, however, is due only shortly before the end of 2004, when negotiations on the revenue sharing system need to be completed.

3.2 Implementation of the March 2003 Stability Programme

In July 2003, the provisional budget[6] was replaced by the regular budget, accompanied by significant reform laws. Most importantly, the government in June adopted a comprehensive pension reform, overcoming stiff political opposition, (see special section below). Second, the first stage of the income tax relief was decided and will take effect as of 1 January 2004 (see section on Public Finances in 2004 below).

In terms of budgetary developments two aspects are worth mentioning. First, the budgetary outcome for 2002 was significantly better than indicated in spring and second, the budgetary impact of the flood disaster in summer 2002 is less pronounced than expected.

As to the year 2002, budgetary data were revised and final figures indicate that government finances, although weakening by 0.4 percentage point, remained[7] close to balance. The general government deficit amounted to 0.1% instead of 0.6% as indicated in the previous stability programme.

Three factors account for this revision. First, real GDP growth in 2002 was revised upwards by half a percentage point to 1.4% in the latest national accounts data release of October 2003. As a consequence, the output gap closed instead of turning negative, and hence the actual deficit corresponded to the cyclically-adjusted balance, whereas the previous growth scenario would have resulted in a small negative cyclical component of some 0.1 percentage point. Second, VAT revenues in February 2003, to be credited to the year 2002 due to the obligatory "time-adjusted cash" calculation method, exceeded expectations and account for almost 0.2 p.p. of the deficit revision. Third, surpluses for both Länder and communities, although having declined slightly in terms of GDP, turned out higher than forecast, by 0.1 percentage point each.

As regards 2003, new projections relating to the flood disaster[8] in summer 2002 indicate that the flood-related impact on the deficit in 2003 is considerably lower and could remain below 0.2% of GDP. Originally, the flood-related budgetary spending and revenue shortfalls were projected to increase the deficit in 2003 by 0.45% of GDP. Notwithstanding these distinctly favourable developments, the updated programme maintains its general government deficit forecast for 2003.

The estimated output gaps in 2003 are equivalent in the previous and the new programme update, because the upward revision of output growth in 2002 and the subdued prospects for

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6 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.

7 Reminder: In 2001, the general government financial position moved to a surplus of 0.3% of GDP, the first in 25 years , improving by a strong 1.8 percentage points in nominal terms and by as much as 2.4 percentage points in cyclically-adjusted terms (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).

8 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.

2003 offset each other[9]. As a consequence, the estimated cyclical component amounts to -0.3% of GDP in both the update and its predecessor. Yet, the update projects a considerably larger rise in the cyclically-adjusted deficit compared with the previous programme, without providing additional information or convincing explanations.

In the previous update of the programme, the cyclically-adjusted balance in 2003 was projected to deteriorate by 0.5 percentage point, fully explained by the one-off effect of expenditure related to the August 2002 flood disaster. Therefore, the underlying budgetary position could have been considered close to balance. However, the new update expects the cyclically-adjusted balance to deteriorate by 0.8 percentage point to -1.0% of GDP, despite the downward revision of the flood-related budgetary impact by some 0.3 percentage point.

In their autumn 2003 exercise, the Commission services forecast the deficit in 2003 to widen by a smaller margin to 1.0% of GDP. In cyclically adjusted terms the balance would thus deteriorate by half a percentage point on account of the flood disaster, based, however, on the assumption that not all flood-related funds would be called upon, and discretionary spending increases. As the latest official estimates indicate an even smaller impact of the floods and taking also into account cash-data for the federal government available until the end of November, a smaller rise in the deficit seems possible.

- *The pension reform 2003*

The most noteworthy development in 2003 was a comprehensive overhaul of the pension system, for a long time the politically most sensitive and, with respect to long-term sustainability of public finances, most important issue. After intensive negotiations the Austrian parliament adopted a pension reform law on 11 June 2003, concerning both the public and the private sector pension regimes. While the initial proposal was somewhat diluted in the parliamentary process, the reform can nevertheless be considered a major step in improving the longer term prospects of Austria's public finances.

The modifications should enhance the actuarial fairness of the pay-as-you-go scheme and raise the effective retirement age as well as the labour force participation of older workers. Measures[10] start as of 2004, and should thus contain the increase in public pension spending already in the short-term, notwithstanding the long-term benefits to be reaped until far beyond the updated stability programme's forecast horizon.

Notwithstanding the overall merits of the reform, a few shortcomings remain both with regard to the long-term budgetary impact and intergenerational fairness:

1. The uniform 10 percent cap on benefit "losses" implies that benefits are determined essentially by the old formula, reduced by 10%. Since this cap has no expiration date, it renders the long-term impact of the pension reform uncertain. It thus also represents a cap on enhancing fairness between generations, an explicit objective listed in the update. Moreover, the notion of benefit "losses" is an artefact, misleadingly suggesting that benefit levels based on the old formula could have been maintained in the long run.

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9 The divergence in potential growth is insignificant: Nov. 2003 update 1.9%, March 2003 update 2.0%

10 The reference period for calculating pension benefits will be extended, eventually to life-long earnings. The annual accruals rate for pension benefits will be lowered. As a result the maximum replacement ratio will be attained after 45 instead of 40 contribution years. Early retirement will be abolished, the gradual retirement scheme for older workers ("Altersteilzeit") modified and the retirement age for persons with particularly long contribution periods raised. Incentives to stay in employment are strengthened by a so-called bonus/malus system.

2. Long transition periods will delay the exonerating effect on public finances and undermine to some extent the fairness between generations. In particular, the phasing-in period for early retirement which should have been abolished by 2013 in the initial proposal, was extended until 2017.
3. Relatively low revaluation of early contribution years in the framework of extending the reference period for calculating pension benefits implies that individuals with a flat earnings profile will receive lower benefits than persons with a steeper profile, even if in absolute terms their accumulated pension contributions are equivalent.

The Austrian authorities project the long-run upsurge in public pension spending to abate noticeably. The increase in expenditure for private employees' pension schemes expected until 2050 is cut by more than one third. In addition, considerable savings are projected for the civil servants' pension schemes. For a fuller treatment of the new budgetary outlook see the long-term sustainability assessment below.

3.3 Public finances in 2004

The authorities project the deficit in 2004 to almost halve, narrowing to 0.7% of GDP after 1.3% in 2003. The cyclically-adjusted deficit is forecast to shrink by 0.6 percentage point to 0.4% of GDP. The projected decline of the nominal deficit is maintained, although GDP growth in the update is assumed to pick up more strongly, accelerating by a full percentage point instead of 0.6 percentage point as assumed in the previous programme. This is nevertheless plausible, since the output gap in 2004 is estimated at 1.0% of GDP in both the update and its predecessor (same output gap in 2003 and basically unchanged outlook for real GDP growth in 2004). Thus, the estimated cyclical component remains unchanged at 0.3 percentage points.

The Commission services, in their autumn 2003 exercise, forecast the deficit in 2004 to narrow to 0.6% of GDP from a more optimistic deficit forecast of 1.0% of GDP for 2003, under the assumption that the surplus obtained by lower levels of government will not improve as expected by the updated stability programme. The expected reduction in the cyclically-adjusted balance is brought about by the ongoing reduction of government personnel, first effects of the recent pension reform combined with the continued exonerating effects of previous changes to the pension system.

On 1 January 2004 the first step of a tax reform will take effect, amounting to some € 0.5 billion or 0.25% of GDP. Taxes for low and middle incomes will be lowered through higher tax allowances and preferential taxation for retained profits will be introduced. While virtually no budgetary impact will be felt in 2004, the tax relief will increasingly weigh on government finances in 2005 and 2006. Moreover, non-wage labour costs, in particular for older workers, will be reduced, as measure that had been repeatedly postponed. In 2003 already, the 13th monthly VAT prepayment was abolished. Last but not least, the ecological components of the tax system are strengthened. Energy and mineral oil taxes will be raised 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. On balance, the tax measures largely offset each other, resulting in a neutral cumulative net effect on the budgets 2003 and 2004.

Total expenditure is forecast to drop noticeably in 2004 by 1.2 percentage point to 50.7% of GDP, according to the update. However, such a marked decline in the expenditure-to-GDP-ratio appears too optimistic. Although not indicated in the update, savings are estimated to total some 0.8% of GDP in 2004, according to information from the Finance Ministry.

3.4 Targets and adjustment in 2005 and beyond

The unchanged budgetary strategy implies that the sizeable income tax relief, totalling 1.3% of GDP, will not be compensated by commensurate spending cuts, as requested by the Council in its opinion on the previous programme update[11]. This is particularly the case for the second step of the tax relief, planned to take effect in 2005 and to amount to € 2½ billion or more than 1% of GDP.

The update projects the tax intake in 2005 to remain at the same level as in 2004, despite an expected nominal GDP growth of 4%. As a consequence, the revenue-to-GDP-ratio is forecast to drop considerably in 2005 by 1.5 percentage points to 48.5%.

As regards new developments on the expenditure side, an additional economic stimulus package[12], the third in a period of somewhat more than 1½ years, will burden the budget in 2005 by some 0.2% of GDP. In terms of structural savings, the update confirms the structural measures presented in the previous programme.

As a result, the cyclically-adjusted deficit will rise by a full percentage point to 1.4% of GDP according to the Commission services estimate or by 0.9 percentage point to 1.3% as indicated in the programme, thus moving considerably away from close-to-balance. As from 2006, the deficit in cyclically adjusted terms is estimated to start narrowing again, remaining at ½ % of GDP in 2007. The improvement envisaged for 2006 is less than 0.5% of GDP as required for those countries which have not yet attained a budgetary position close to balance[13].

- *Commission evaluation*

In principle, the planned tax cuts are a welcome step towards lowering the tax ratio. Having increased sharply due to the revenue side consolidation in 2001, such a reform could render supply side conditions more growth friendly, provided it reduces distortions and enhances the system's transparency. Ensuring competitiveness should also be an important objective, in particular against the background of recent tax reforms in neighbouring countries. The Finance Minister has repeatedly stated his preference for an emphasis on a reform of corporate taxes, rather than just personal income tax cuts.

However, reiterating the assessment of the previous programme, such a substantial tax relief should be financed by more decisive action on the expenditure side, thereby limiting the rise in the cyclically-adjusted deficit. Given that in structural terms the planned budgetary position in 2004 complies with the close-to-balance requirement of the Stability and Growth Pact, the government should strive to maintain that position.

The projected cyclical upswing would not only facilitate but indeed warrant commensurate spending cuts in order to avoid a pro-cyclical effect. The Austrian economy is forecast to expand at full cruising speed by 2005. Real GDP growth is projected at 2.5%, clearly above trend, thus causing the still negative output gap to close rapidly. However, additional saving measures are not foreseen in the updated programme.

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[11] The Council considered the March 2003 stability programme to be "*only partly in line with the requirements of the Stability and Growth Pact*"[11]. The Council criticised that the short-term target of maintaining budgetary balance was abandoned, regretting "*that the Austrian government will not reach its previous target of maintaining budgetary balance and moving to a small surplus in 2004 and 2005.*"

[12] Adopted in 2003 and starting in 2004, the full budgetary impact will be felt in 2005.

[13] Commission communication of 27.11.2002 , COM (2002) 668 final, and Ecofin Council conclusions of March 2003.

In terms of substance, enhancing the tax system's transparency and reducing its complexity are not explicit objectives, although this would have been welcome. While the tax measures in 2000 and thereafter broadened the tax base, exemptions and allowances introduced in 2004 undermine this achievement.

The third fiscal stimulus package will also have a pro-cyclical impact, enhancing the effect of the planned tax relief. This package comes on top of two fiscal packages[14] adopted earlier, estimated to burden the budget by some 0.3% of GDP on a permanent basis as of 2003. With the benefit of hindsight, these stimulus packages actually fulfilled their purpose, given the delay in the economic recovery, by exerting a counter-cyclical effect. However, burdening public finances on a permanent basis is at odds with the temporary nature of measures intended to support demand in a period of sluggish growth.

- *Main risks*

The budgetary objectives for 2005 and beyond hinge crucially on the successful implementation of the envisaged expenditure cuts. Even if all measures were realised to their full extent, the deficit is projected to increase noticeably in 2005, 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, let alone additional discretionary spending increases, 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, is introduced as envisaged. Clearly, the main challenges relate to the full implementation of the savings plans and are thus on the political side. So far, however, the government has proved quite successful in implementing its economic policy plans, as demonstrated in the context of the pension reform.

Moreover, the Commission services have calculated the likely impact on social security contributions resulting from employment growth as projected in its Autumn 2003 forecast, which is lower than assumed in the update. The results[15] reveal that in the Commission scenario additional savings efforts of 0.1% of GDP each in 2005 and subsequent years would be necessary in order to comply with the deficit targets. Hence, there is a risk that, on government plans, the cyclically-adjusted deficit in 2007 may not reach a position close to balance.

3.5 Sensitivity analysis

The Commission services carried out a sensitivity analysis to assess the risk to the programme targets from different growth assumptions. The key assumption on the expenditure side is that the nominal levels of non-cyclical expenditure planned by the government are implemented regardless of economic developments. This may appear at first sight to be a strong assumption, but it is a reasonably good approximation in the light of high degree of inertia in the budgetary implementation process. On the revenue side, on the other hand, the standard hypothesis applies, i.e. that there is a stable relationship between revenues and economic growth.

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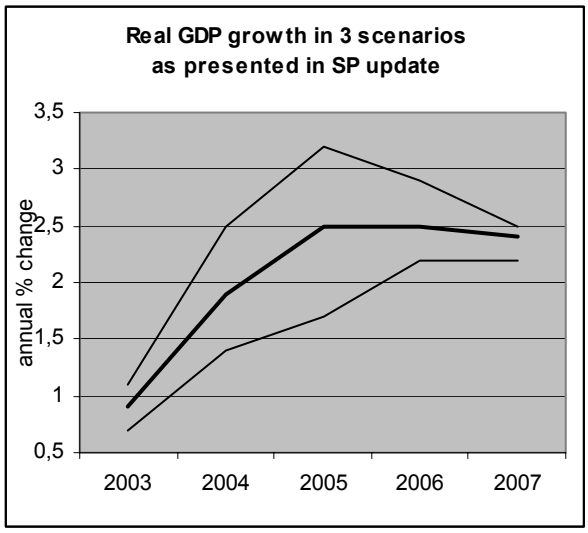
[14] Adopted in December 2001 and September 2002 in the light of the cyclical downturn; intended to temporarily increase private investment and foster human capital formation and innovation by preferential tax treatment. In addition, a new pension savings scheme was introduced, aiming at strengthening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

[15] $\Delta sc_t = 0.008 + 0.349 * \Delta sc_{t-1} + 0.655 * \Delta comp_t + \varepsilon$
where *sc* denotes social security contributions, *comp* total compensation of employees

The results indicate that Austria would withstand a normal cyclical downturn without risking to approach the 3% of GDP reference value for the deficit throughout the programme period. A symmetric variation in real GDP growth rates by ±0.5 percentage point from the baseline, starting as of 2004, would cause the cyclically-adjusted balance to diverge between ±0.2 and ±0.5 percentage point from the central scenario, increasing for the later years of the projection period due to the to the cumulative nature of the growth variation.

In 2005, the critical year of the planned budget path, the CAB would reach 1.6% of GDP in the case of weaker growth, implying an additional savings effort of 0.3 percentage point to adhere to the nominal budget target of 1.5% set for that year. In the event of higher growth, the required adjustment need would decline by the same margin.

In the higher growth scenario (±0.5 percentage point), the budgetary outcome would not be close to balance in any additional years other than 2004 and 2007, neither in cyclically-adjusted nor in nominal terms. Under the behavioural assumptions spelt out above, only if the growth variation is increased to 1 percentage point, then the budgetary outcome could be considered close to balance in all years of the projection period.



The updated programme also presents alternative growth scenarios to assess the consequences for public finances. As in the previous programme, however, the scenario assumptions are somewhat unconventional and calculation results opaque and hard to evaluate. First, and most important, the implicit budget sensitivity to the output gap varies strongly over the years in all three scenarios (from 0.0 to 0.5). While the output gap for the central scenario is specified in the update, it had to be derived for the low/high growth scenario in a rather basic way[16]. While such variations of the implicit budget sensitivity to the output gap cannot be excluded, only sophisticated and thus less transparent calculation techniques applying detailed break-downs can generate such results. However, no such references are made in the update. Second, also within the low/high growth scenario the growth rate divergence from the baseline varies over the years, not always for obvious reasons (ranging from 0.1 to 0.7 percentage point in case of stronger growth and from -0.2 to -0.8 p.p. in the weaker growth scenario). In the year 2005, a faster acceleration in output growth induced by the tax relief cannot be excluded. However, a +0.7 percentage point deviation from the baseline in the high growth scenario appears exaggerated, given that in the central scenario real GDP growth is forecast to pick up to 2.5%. Conversely, in 2007 the deviation in the low growth scenario amounts to a mere 0.2 percentage point, implying that real GDP would still expand at a rate of 2.2%, which is still clearly above potential and thus not a prudent assumption.

Therefore, the Commission services have carried out an additional sensitivity analysis, applying the method described in the first paragraph, to mimic the growth deviations of the updated stability programme. Hence, growth divergences from the baseline start already in 2003 and vary over the years (see **Table 6** below). More specifically, in 2005, the year of particular interest, real GDP expansion in the high growth scenario is 0.7 percentage point above the baseline, assuming that the tax reform and structural reforms boost economic

[16] Starting with the output gap (Ygap) in the central scenario in 2002 by adding the difference between actual (Y) and potential output (YP) in year t+1 to the output gap in year t: $Ygap_{t+1}=Ygap_t+(Y-YP)_{t+1}$

activity. For reasons of symmetry, the output expansion in the weak growth scenario of the update is 0.8 percentage point below the baseline.

The results are broadly similar to the symmetric ±0.5 percentage point growth variation, modelled above. The cyclically adjusted deficit in 2005 in the event of weaker growth is also estimated at 1.6% of GDP.

Table 6: Sensitivity to GDP growth - Mimicking SP growth rate deviations from central scenario

	2003	2004	2005	2006	2007
CAB estimates	In % of GDP				
CAB baseline	-0,9	-0,3	-1,3	-1,1	-0,5
CAB strong growth	-0,7	0,0	-0,9	-0,6	0,0
CAB weak growth	-1,2	-0,6	-1,6	-1,5	-1,0
Differences from baseline	In % point of GDP				
CAB strong growth	0,2	0,3	0,4	0,5	0,6
CAB weak growth	-0,2	-0,3	-0,3	-0,4	-0,5
Real GDP growth, strong growth	0,2	0,6	0,7	0,4	0,1
Real GDP growth, weak growth	-0,2	-0,5	-0,8	-0,3	-0,2

Source: DG ECFIN

3.6 Debt ratio

The debt-to-GDP-ratio was significantly revised upwards in 2001 and 2002, resulting in an increase in the debt-to-GDP-ratio by 6.4 percentage points to 67.1% in 2001. The reasons for the two revisions were discussed in detail in the Commission's assessment[17] of the previous update of the Austrian Stability Programme and in the latest Public Finance Report[18].

The updated stability programme expects the debt ratio to fall marginally below the 60% reference value in 2007, declining by 6.8 percentage points from 2002. The starting point in 2002 with a debt-to-GDP ratio of 66.7% is more than a percentage point lower than in the previous version of the programme. National accounts data revisions, resulting in higher nominal GDP entailing an increase in the denominator, account for more than half of this difference. The remainder results mainly from a downward revision of the debt level, decreasing the nominator. The federal government borrowed € 1.3 billion or 0.6% of GDP from the province of Upper Austria, which previously was reported twice by mistake but consolidated in the latest debt reporting.

The projected adjustment remains relatively speedy, in particular toward the end of the projection period. First, state-owned enterprises, which were financed in the past by government debt emission ("Rechtsträgerfinanzierung"), will gradually reimburse their balances outstanding and the government will cease to issue new bonds for this purpose. Second and most importantly, proceeds from further privatisations, such as Telekom Austria,

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17 European Commission, DG Economic and Financial Affairs: 2002 Update of the Stability Programme of Austria (2003-2007) – An Assessment, ECFIN/192/03-EN, 28 April 2003, available on the web, see at http://europa.eu.int/comm/economy_finance/about/activities/sgp/ca_en.htm

18 European Commission, Directorate-General for Economic and Financial Affairs: Public finances in EMU 2003, in European Economy Nr. 3/2003; available on the web, see at http://europa.eu.int/comm/economy_finance/publications/european_economy/public_finances2003_en.htm

are expected. As a consequence, the negative stock-flow adjustment in the later years covered by the programme will be sizeable and hence contribute to the planned decline in the debt ratio. Particularly pronounced is the projected turnaround of the contribution of the stock-flow adjustment to the change in the debt ratio in 2005. Implicitly, privatisation proceeds would amount to € 2.6 billion or 1.1 of GDP, an assumption which is not without risks. However, estimates relating to this special factor are not made explicit (see Table A-3 in annex), although this would have been warranted given its importance.

As a consequence, the interest burden is expected to gradually decrease, given that the update projects stable effective average interest rates (5.3%). This assumption appears realistic given that interest rates are fixed for more than 90% of government debt and the average remaining maturity is almost 6 years. This explains why the updated programme does not include a high-interest –rate scenario.

The primary balance and nominal GDP growth are forecast to contribute to almost equal extent to the projected debt reduction. The contribution of the primary balance is expected to fluctuate. Noteworthy - and not further commented upon in the update - is a sharp drop in the primary surplus by more than a full percentage point in 2003, similar to the forecast in the previous programme.

However, as discussed earlier, the general government deficit in 2003 might turn out better than indicated in the update, to be reflected in the primary surplus. For 2005, an additional decline in the contribution of the primary surplus is projected, caused by revenue shortfalls relating to the tax reform. On average from 2003-2007, the primary surplus should contribute by 2.4 percentage points annually to the projected debt reduction.

The contribution of economic growth is projected to remain fairly steady from 2002 to 2004, increasing thereafter to 2½ percentage points until the end of the forecast period. Thus, between 2003 and 2007 nominal GDP growth is estimated to contribute to the reduction of the debt-to-GDP-ratio on average by 2.2 percentage points annually.

However, the update's assumptions hinge crucially on high nominal GDP growth. Should nominal GDP turn out slightly lower than assumed in the update, then the government debt ratio will remain above the 60% benchmark even in 2007. To assess this risk, DG ECFIN has calculated alternative scenarios[19]. In a first scenario, nominal GDP growth was calculated on basis the Commission's Autumn 2003 forecast for the GDP deflator. In a second scenario, this was combined with lower with real GDP growth rates 2006 and 2007. In a third and fourth scenario, the level of government debt is slightly reduced due to an assumed lower-than-targeted deficit in 2003, divided by the two alternative nominal GDP calculations. In all of the four scenarios, even in the most benign cases assuming a lower debt level due to lower deficit in 2003 as forecast by the Commission, the debt-to-GDP-ratio would remain above 60% of GDP in 2007. Moreover, should privatisation proceeds not materialise as expected, the additional risk would correspond to up to 1.1% of GDP. Hence, in the worst case the debt ratio could stand close to 62% of GDP in 2007.

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[19] Scenario 1: GDP deflator as projected in the Commission's Autumn 2003 forecast for the years 2003-2005 used to calculate nominal GDP, ceteris paribus; resulting debt-to-GDP ratio 60.3% in 2007.
Scenario 2: same as scenario 1 with real GDP growth rates 2006 and 2007 adapted (to 2.1% for both years) such that average annual real growth from 2003-07 equals average trend growth rate (of 1.9%) according to Commission's Autumn 2003 forecast for the same period; resulting debt-to-GDP ratio 60.7% in 2007.
Scenario 3 and 4: Commission's Autumn 2003 forecast expects better deficit outcome in 2003 (1% of GDP instead of 1.3%). Government debt reduced in 2003 and following years reduced accordingly (by € 0.67 billion) = adapted debt series. For scenario 3: adapted debt series / nominal GDP as of scenario 1; resulting debt-to-GDP ratio 60.1% in 2007. For scenario 4: adapted debt series / nominal GDP as of scenario 2; resulting debt-to-GDP ratio 60.5% in 2007.

4. QUALITY OF PUBLIC FINANCES

4.1 Composion of revenue and expenditure

The budgetary strategy pursued by the government consists of three building blocks: Structural savings, tax measures and increases in discretionary spending for various purposes.

As regards structural savings, the bulk of measures is already in the implementation phase. Hence, remaining risks are limited and relate only to forecasting uncertainties concerning the size of expected savings. The effect of cost-cutting measures in public administration, announced in the previous programme to amount to € 1.3 billion by 2006, was scaled down somewhat according to more recent information. What remains to be decided is the planned reform of the health-insurance funds, which can be expected for 2005 at the earliest. There is further the intention to dismantle duplication in public administration at the lower levels of government. Lately, these plans have become more concrete as the Austrian Convention (see footnote 5 on page 6) is focusing on this issue. In total, the cumulated impact of the structural savings up to 2006 is estimated at 1.2% of GDP.

As for tax measures, the so-called fiscal stimulus packages I and II (see footnote 16 on page 15), will have a permanent budgetary impact. The planned tax relief appears appropriate in the light of the rather high tax burden in Austria. Particularly welcome is the reduction in non-wage labour costs, which was postponed several times. In total, revenue reductions up to 2006 are projected to amount to 1.6% of GDP, thereby outweighing the expected structural savings by 0.3 percentage points.

The rise in discretionary expenditure scheduled until the end of the current legislative period is quite substantial. Estimated to amount to 0.6% of GDP by 2006 in cumulated terms, the spending increases offset half of the projected structural savings. Apart from a pay rise in 2004 for civil servants, the measures concern higher spending on R&D, for universities and labour market measures, in conformity with Lisbon targets. By contrast, the increase in already generous family allowances/child benefits is difficult to square with the intention to increase female labour force participation. Adopted in the previous legislation period, the rise in respective expenditure is particularly pronounced until 2004, and should abate thereafter. The cumulated budgetary impact from 2003-2006 is estimated at some ¼ % of GDP.

4.2 Structural Measures and Other Reforms with Likely Budgetary Impact

Similar to the previous programme the update sketches planned or implemented reforms for product, capital and labour markets geared towards improving Austria's attractiveness as a business location. This section contains little information, for good reasons though, as only nine months have passed since submission of the previous programme.

Regarding the capital market, two important elements were implemented. In the framework of the pension reform, the "third pillar" of the pension system will be strengthened. Moreover, the so-called Austrian Corporate Governance Codex was installed, an action plan to strengthen confidence in the market and to increase the market volume. Indeed, the main impediment for international investors so far, was the insufficient depth of the Austrian financial market. With respect to product markets, the programme lists privatisations which have either taken place between March and November 2003. As regards the labour market the programme refers to the National Action Plan for Employment 2003, emphasising the

policy goals integrating the long-term unemployed, raising the employment rate of older workers and youth.

5. SUSTAINABILITY OF PUBLIC FINANCES

5.1 Quantitative indicators

The assessment of the sustainability of Austrian public finances is based on both quantitative and qualitative indicators. The quantitative indicators project debt and budget balance development according to two different scenarios, to take into account uncertainties over the medium term. The "programme" scenario is calculated on the following basis:

- Macroeconomic assumptions on GDP growth from 2008 onwards, interest rates and inflation are based on the agreed assumptions used in the Economic Policy Committee (EPC);
- The projections for age-related expenditures come from the stability programme, complemented with the Economic Policy Committee harmonised projections.
- The projections for government revenues come from the programme. They are kept constant at the (cyclically adjusted) level in 2007.
- The starting point for gross debt and the primary balance are the 2007 levels reported in the programme.
- The impact of the 2003 pension reform foreseen in the programme is assumed to materialize.

A "2003 position" scenario is based on the budgetary data for 2003 in the programme. Debt levels are extrapolated from 2008 to 2050 assuming that no budgetary consolidation is achieved, i.e. the cyclically adjusted primary balance in 2008 remains the same as the 2003 level and no stock-flow operations take place.

The table below presents the debt and the budget balance development according to the two different scenarios. Projections are based on national projections on pensions, health care and other social security expenditures while education and unemployment benefits projections rely on the EPC common exercise. Overall, age-related expenditure is foreseen to increase by 1.6% of GDP between 2008 and 2050. Compared with last year's assessment, a lower increase in pension expenditure is foreseen. Also, savings due a reduction of unemployment benefits and education expenditures have been included.

Table 7: Long term sustainability

Long term sustainability: summary results
Austria

Main assumptions - baseline scenario (as % GDP)	2008	2010	2020	2030	2040	2050	changes
Total age-related spending	26,9	26,8	27,3	28,5	29,0	28,4	1,6
Pensions	14,6	14,6	14,9	15,8	15,8	15,0	0,4
Health	5,2	5,2	5,6	6,0	6,3	6,4	1,2
Education'	5,6	5,5	5,3	5,1	5,1	5,0	-0,6
Unemployment benefits'	0,7	0,7	0,5	0,5	0,6	0,5	-0,2
Others	0,8	0,8	1,0	1,1	1,3	1,5	0,7
*Total primary non age-related spending**	18,3						
Total revenues	47,9	47,9	47,9	47,9	47,9	47,9	0,0

' based on the EPC projections

* constant

Results (as % GDP)	2008	2010	2020	2030	2040	2050	changes
Programme scenario							
Debt	57,9	53,9	35,9	24,4	20,8	15,9	-42,0
Net borrowing	-0,5	-0,2	0,3	-0,3	-0,6	0,2	0,7
2003 position scenario							
Debt	59,2	55,4	38,8	28,8	27,4	25,0	-34,2
Net borrowing	-0,7	-0,4	0,1	-0,6	-1,0	-0,3	0,3

Sustainability gap	S1*	S2**
Programme scenario	0,1	0,3
2003 position scenario	0,2	0,5

* 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: 12.2%

** 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.

It is possible to verify whether the projected level of debt respects the requirement to stay below 60% of GDP reference value for public debt at all times. Failure to do so would *a priori* indicate that there may be a risk of budgetary imbalances emerging in light of ageing population and that measures may be required to place public finances on a more sustainable footing.

According to the quantitative indicators, Austria is on a sustainable path. The impact of the pension reform on public expenditures in the long run will allow a reduction of the debt to GDP ratio: if this impact fully materializes, a correction of about 1.5 p.p. of GDP will add to the correction already foreseen last year by Austrian authorities of 1 p.p. of GDP as a result of higher labour supply due to the 2000 pension reform. In total, while EPC 2001 projections showed a level of 18.3% of GDP for pension expenditures in 2040, new figures provided in the updated programme foresee a level of 15.8% of GDP.

No sustainability gap therefore arises. The current policies allow the SGP requirements in terms of gross debt to be respected all times.

5.2 Additional qualitative features

As underlined in the EPC report on "The impact of ageing populations on public finances: overview of analysis carried out at EU level and proposals for a future work programme"[20]

[20] Available at http://europa.eu.int/comm/economy_finance/epc/documents/2003/pensionmaster_en.pdf

(October 2003), several qualitative factors should be taken on board to avoid a mechanistic interpretation of the quantitative indicators. On the positive side, the Austrian authorities passed already a significant pension reform seeking to discourage early retirement and contain the rise in the earnings replacement ratio. The latter implication represents an incentive to prolong working careers since the maximum replacement rate (80%) will be reached only after 45 instead of 40 contribution years. However, projected results call for vigilance. First, the cap on reform-related pension benefit losses of 10% until 2032 render real savings that can be achieved in the next 30 years rather uncertain. Second, results rely strongly on the assumed increase of participation rates among older workers as a consequence of the pension reform. The divergence of the post-reform estimates from initial EPC projections is significant and the Commission quantitative assessment incorporates also possible savings from education and unemployment benefits expenditures. Should the foreseen savings not materialize fully, a worse scenario would be likely.

5.3 Overall assessment

The Commission considers that, on the basis of the current policies, Austria appears to be in a relative good position to meet the budgetary costs associated with ageing populations if the impact of the pension reform materializes fully.

The budgetary strategy outlined in the programme is compatible with improving the sustainability of public finances. The strategy is mainly based on the implementation of the pension reform and on its impact on labour market behaviour. Thus, a strict monitoring of pension expenditure trends and more transparency on those factors behind the foreseen savings is crucial to confirm the improved situation.

6. OVERALL ASSESSMENT OF COMPLIANCE WITH THE SGP

The updated Austrian stability programme broadly complies with the code of conduct[21] endorsed by the Council.

Although the structural budgetary position weakened slightly in 2002, general government finances remained close to balance for the second consecutive year. Due to the output gap having closed, the actual balance corresponded to the structural one. Going forward, the Austrian authorities, by passing a major pension reform last July, have taken an important step towards improving Austria's budgetary position in a longer-term perspective. Some other measures, enacted or envisaged, are also likely to reduce upward pressure on government expenditure or enable the economy to move to a higher pace of growth. However, as foreseen by the programme update, a substantial cut in direct taxes to take effect in 2005 will not be accompanied by *pari passu* expenditure restraint, such that the hard-won balanced budget position will at least temporarily be abandoned.

In nominal terms, the general government accounts will revert to a position close to balance only in 2007. The cyclically-adjusted deficit is expected to deviate markedly from "close-to-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.

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. If,

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[21] Revised Opinion of the Economic and Financial Committee on the content and format of stability and converge programmes, document EFC/ECFIN/404/01 – REV 1 of 27.6.2001 endorsed by the Ecofin Council on 10.7.2001.

however, structural spending cuts were only partly implemented, the departure from "close-to-balance" would become permanent, and, in 2005, the safety margin below the 3% reference value could turn out to be insufficient in the event of a normal cyclical downturn.

General government debt is forecast to decline consistently throughout the programme period, dropping marginally to below the 60% threshold by 2007. However, if growth should turn out lower than projected or if the proceeds from planned privatisations remain below expectations, the debt-to-GDP-ratio would remain above the 60% threshold even in 2007.

The updated programme complies only in part with the Broad Economic Policy Guidelines for 2003. Specifically, "securing a cyclically-adjusted budgetary position close to balance" is only partly respected. Moreover, in 2005, the general guideline requesting Member States to avoid "particularly when growth resumes, [avoid] pro-cyclical policies that counteract the full and symmetric play of the automatic stabilisers over the cycle" is not observed. As concerns *Länder* and communities, the update is silent on "structural expenditure savings, (also) at lower levels of government", which are required to attain permanent surpluses, an obligation enshrined in a national stability pact.

ANNEX 1:
SUMMARY TABLES DERIVED FROM THE 2004 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)	0.8	1.4	0.9	1.9	2.5	2.5	2.4
GDP *level* at *current* market prices	212.5	218.3	223.3	230.5	239.7	249	258.7
GDP deflator	2.1	1.4	1.4	1.3	1.5	1.4	1.5
HICP change	2.3	1.7	1.3	1.2	1.5	1.7	1.8
Employment growth	--	--	--	--	--	--	--
Dependent employment*	0.5	0.2	0.2	0.5	0.9	1.0	0.8
Dependent employment (ESA95 def.) **			0.1	0.6	0.9	1.0	0.8
Labour productivity growth ***	0.3	1.4	0.8	1.3	1.6	1.5	1.6
Sources of growth: percentage changes at constant prices							
1. Private consumption expenditure	1.4	0.8	1.4	2	2	1.8	1.4
2. Government consumption expenditure	-1.4	0.1	0.0	0.3	0.2	0.2	0.5
3. Gross fixed capital formation	-2.5	-3.3	1.6	2.7	3.7	3.9	3.6
4. Changes in inventories and net acquisition of valuables as a % of GDP	-0.3	0.3	-0.1	0.0	0.0	0.1	0.0
5. Exports of goods and services	7.5	3.7	-0.2	2.9	5.6	5.4	5.3
6. Imports of goods and services	5.9	1.2	0.5	2.8	5	4.8	4.7
Contribution to GDP growth							
7. Final domestic demand (1+2+3)	-0.1	-0.3	1.1	1.8	2	1.9	1.7
8. Change in inventories and net acquisition of valuables (=4)	0.0	0.3	0.0	0.0	0.1	0.1	0.2
9. External balance of goods and services (5-6)	0.9	1.4	-0.2	0.1	0.4	0.5	0.5
Basic assumptions							
Short-term interest rate (annual average)	4.3	3.3	2.3	2.3	3.2	3.2	3.2
Long-term interest rate (annual average)	5.1	5.0	4.1	4.4	4.8	5.0	5.0
USD/€ exchange rate (annual average)	0.896	0.945	1.13	1.16	1.15	1.1	1.1
(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	23.6	24.1	28.3	25.6	24.1	23.9	23.3

* According to social security statistics, i.e. including persons on parental leave
** Commission services' calculation: implicit rate derived from labour productivity growth, i.e. on basis of effective labour force (=ESA95)
*** calculated on basis of 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	-0.1	-1.3	-0.7	-1.5	-1.1	-0.4
2. Central government	-0.5	-0.8	-1.8	-1.4	-2.2	-1.9	-1.1
3. State government	0.5	0.4	0.3	0.4	0.4	0.4	0.4
4. Local government	0.3	0.2	0.2	0.3	0.3	0.3	0.3
5. Social security funds	0.0	0.0	0.0	0.1	0.0	0.0	0.0
General government							
6. Total receipts	52.0	51.2	50.6	50.0	48.5	48.3	48.0
7. Total expenditures	51.8	51.3	51.9	50.7	50.0	49.4	48.4
8. Budget balance	0.3	-0.1	-1.3	-0.7	-1.5	-1.1	-0.4
9. Net interest payments	3.7	3.6	3.6	3.5	3.4	3.3	3.2
10. Primary balance	4.0	3.4	2.3	2.8	2.0	2.2	2.8
Components of revenues							
11. Taxes	29.7	28.9	28.7	28.4	27.3	27.3	27.2
12. Social contributions	16.7	16.6	16.6	16.4	16.3	16.3	16.7
13. Interest income							
14. Other	5.5	5.5	5.2	4.9	4.8	4.6	4.5
15. Total receipts	51.9	51.0	50.5	49.8	48.4	48.1	47.8
Components of expenditures							
16. Collective consumption	7.3	7.0	7.0	7.0	6.9	6.8	6.8
17. Social transfers in kind	11.6	11.6	11.6	11.4	11.2	11.1	10.9
18. Social transfers other than in kind	18.7	18.6	19.2	19.1	18.9	18.8	18.6
19. Interest payments	3.7	3.6	3.6	3.5	3.4	3.3	3.2
20. Subsidies	2.6	2.8	2.7	2.8	2.8	2.8	2.7
21. Gross fixed capital formation	1.2	1.3	1.1	1.0	1.0	1.0	1.0
22. Other	6.8	6.4	6.6	6.0	5.9	5.7	5.4
23. Total expenditures	51.8	51.3	51.9	50.7	50.0	49.4	48.4

Table A- 3. General government debt developments

% of GDP	2001	2002	2003	2004	2005	2006	2007
Gross debt level	67.1	66.7	66.4	65.8	64.1	62.3	59.9
Change in gross debt	2.5	-0.4	-0.3	-0.6	-1.7	-1.8	-2.4
Contributions to change in gross debt							
Primary balance	4	3.5	2.4	2.8	1.9	2.2	2.8
Interest payments	3.7	3.6	3.6	3.5	3.4	3.3	3.2
Nominal GDP growth	-1.6	-1.9	-1.8	-1.8	-2.6	-2.5	-2.5
Other factors influencing the debt ratio	--	--	--	--	--	--	--
Of which: Privatisation receipts	--	--	--	--	--	--	--
p.m. implicit interest rate on debt	5.7	5.4	5.4	5.3	5.3	5.3	5.3

Table A- 4. Cyclical developments

% of GDP		2002	2003	2004	2005	2006	2007
1. GDP growth at constant prices		1.4	0.9	1.9	2.5	2.5	2.4
2. Actual balance*		-0.1	-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 **		1.9	1.9	1.9	2.0	2.0	2.0
5. Output gap		0.0	-1.0	-1.0	-0.5	0.0	0.4
6. Cyclical budgetary component*		0.0	-0.3	-0.3	-0.2	0.0	0.1
7. Cyclically-adjusted balance (2-6)		-0.2	-1.0	-0.4	-1.3	-1.1	-0.5
8. Cyclically-adjusted primary balance (7-3)		3.6	2.6	3.2	2.0	2.2	2.7

*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	0.9	1.4	2	2.5	2.5	2.4
latest update	1.4	0.9	1.9	2.5	2.5	2.4
Difference	0.5	-0.5	-0.1	0.0	0.0	0.0
Actual budget balance						
previous update	-0.6	-1.3	-0.7	-1.5	-1.1	-0.4
latest update*	-0.1	-1.3	-0.7	-1.5	-1.1	-0.4
Difference**	0.5	0.0	0.0	0.0	0.0	0.0
Gross debt levels						
previous update	67.8	67	65.1	63.8	62.1	59.7
latest update	66.7	66.4	65.8	64.1	62.3	59.9
Difference***	-1.1	-0.6	0.7	0.3	0.2	0.2

* 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	51.8	--	--	--	--
Old age pensions	14.6	14.6	14.9	15.8	15.0
Health care (including care for the elderly)	5.1	5.2	5.6	6.0	6.4
Interest payments	3.7	--	--	--	--
Total revenues	52.0	--	--	--	--
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	1.5	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	4.1	3.0	3.0	3.0	3.0

* (Age 15-64)

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

		2002	2003	2004	2005
Basic assumptions					
Short-term interest rate (annual average)		3.3	2.3	2.3	3.2
Long-term interest rate (annual average)		5.0	4.1	4.4	4.8
USD/€ exchange rate (annual average)		0.95	1.13	1.16	1.15
(for non-euro countries) exchange rate vis-à-vis the € (annual average)		--	--	--	--
World excluding EU,GDP growth		3.2	3.9	4.5	4.5
EU-15 GDP growth		1.1	0.8	2.0	2.4
Growth of relevant foreign markets		2.2	4.0	6.5	7.3
World import volumes, excluding EU		--	6.3	8.3	8.6
Oil prices		25.0	28.3	25.6	24.1