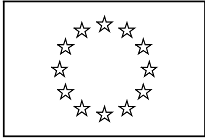

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 7.1.2004
SEC(2004) 9 final

Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Art. 5 of Council Regulation (EC) No. 1466/97 of 7 July 1997

On the updated Stability Programme for Austria, 2003-2007

(presented by the Commission)

EXPLANATORY MEMORANDUM

Council Regulation (EC) No. 1466/97, on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies[1], stipulated that countries participating in the single currency were to submit stability programmes to the Council and the Commission by 1 March 1999. In accordance with Article 5 of this Regulation, the Council had to examine each stability programme based on the assessments prepared by the Commission and the Committee set up by Article 114 (formerly 109c) of the Treaty (from 1 January 1999, the Economic and Financial Committee). The Commission adopted a recommendation on each programme. On the basis of this recommendation and after having consulted the Economic and Financial Committee, the Council delivered an opinion, following its examination of the programme.

Austria's first stability programme covering the period 1998-2002 was submitted on 30 November 1998 and assessed by the Council on 18 January 1999[2].

Austria submitted its fifth and most recent update of the stability programme, covering the period 2003-2007, on 18 November 2003. The Commission services have carried out a technical evaluation of this updated programme, taking into account the information provided in accordance with the Code of Conduct[3], the Autumn forecasts as well as subsequent evaluations, the commonly agreed methodology for the estimation of cyclically-adjusted balances, the recommendations in the Broad Economic Policy Guidelines and the principles laid down in the Communication of the Commission to the Council of 27 November 2002 on strengthening the co-ordination of budgetary policies[4]. This evaluation warrants the following assessment:

> 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

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1 OJ L 209, 2.8.1997. The documents referred to in this text can be found at the following web site http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

2 OJ C 42/5, 17.2.1999.

3 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.

4 COM(2002) 668 final, 27.11.2002.

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-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 budgetary outcome 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, which 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[5] 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-

5 2003 BEPGs – Country specific recommendation: "[…], Austria is recommended to: 1. Implement measures leading to structural expenditure savings, also at lower levels of government, so as to lower the high tax burden, while securing a cyclically-adjusted budgetary position close to balance (GL 1).

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.

Based on this assessment, the Commission has adopted the attached recommendation for a Council Opinion on the Stability Programme update of Austria and is forwarding it to the Council.

Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Art. 5 of Council Regulation (EC) No. 1466/97 of 7 July 1997

On the updated Stability Programme for Austria, 2003-2007

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council regulation (EC) No. 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[6], and in particular Article 5(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

On [20 January 2003] the Council examined the updated stability programme for Austria which covers the period 2003-2007. The programme was submitted on 18 November 2003 and broadly complies with the revised "code of conduct on the content and format of stability and converge programmes"[7]. However, more quantitative information, as contained in the twin budget 2003/2004, with detailed estimates for individual budgetary measures would have proved useful and should have been included.

The budgetary strategy of the updated programme remains unchanged, with a distinct long-term focus. Substantial structural savings combined with sizeable tax cuts, while causing a temporary widening of the cyclically-adjusted deficit in 2005, should entail a steady decline in expenditure and revenue ratios and in the debt ratio.

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. Moreover, real GDP growth in 2006 and 2007 would remain above potential. The implicit closing of the output gap, however, would not seem implausible after a period of sluggish growth, due to the

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6 OJ L 209/1, 2.8.1997. The documents referred to in this text can be found at the following web site http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

7 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.

positive impact of recent and ongoing structural reforms and enlargement, given that macroeconomic imbalances are absent in the Austrian economy.

The update maintains the budgetary targets set in the previous programme. The cyclically-adjusted balance, based on Commission calculations according to the commonly agreed methodology, is set to deteriorate by 0.9 percentage points to 1.0% of GDP in 2003 and, after a temporary improvement, by 1.0 percentage point to 1.4% of GDP in 2005 due cuts in direct taxes. Despite narrowing thereafter, the cyclically-adjusted deficit will decline to 0.5% of GDP only in 2007. Thus, the cyclically-adjusted deficit stays close to balance only in the years 2004 and 2007.

The budgetary stance in the updated programme should provide a sufficient safety margin against breaching the 3% of GDP deficit ceiling with normal macroeconomic fluctuations. However, under plausible macroeconomic and budgetary assumptions, the medium-term objective of a budgetary position of close to balance may not be achieved over the programme period. Although 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, risks regarding expected savings and surpluses from lower government levels are non-negligible. Moreover, if the announced expenditure savings were only partly implemented or do not materialize as intended, the planned temporary departure from the medium-term target may turn out to be persistent. The government gross debt is expected to decrease steadily from 66.7% of GDP in 2002 to just below 60% in 2007. This forecast hinges crucially on optimistic nominal GDP growth assumptions and 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.

After the 2003 pension reform, Austria appears to be in a considerably better position than before to meet the budgetary costs of an ageing population. This evaluation, however, needs to be confirmed by actual developments. First, projections assume a reform-induced strong increase in participation rates. Second, the 10 percent cap on benefit losses compared with the status quo ante renders long-term budgetary effects rather uncertain. Moreover, exonerating effects on government finances are unnecessarily delayed due to a disproportionately long transition period for abolishing early retirement until 2017.

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.