EUROPEAN COMMISSION
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NOVEMBER 2005 UPDATE

OF THE STABILITY PROGRAMME OF AUSTRIA

(2005-2008)

AN ASSESSMENT

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SUMMARY AND CONCLUSIONS[1]

On 30 November 2005 Austria submitted its most recent update of the stability programme, which covers the period from 2005 to 2008. The programme broadly follows the model structure and data provision requirements for stability and convergence programmes specified in the new code of conduct[2].

In its opinion of 18 January 2005 on the previous update of the stability programme, covering the period 2004-2008, the Council invited Austria to achieve a higher degree of front-loading in the overall budget consolidation path and to lay out in greater detail the specific measures through which a significant budget consolidation could be achieved in the last two years of the programme.

In the last decade, the Austrian economy grew on average by 2.2% per year in real terms, matching the growth rate for the euro zone as a whole. While job creation has been less dynamic than in the euro area, Austria still enjoys one of the lowest unemployment rates in the whole EU. In budgetary terms, the country achieved a "surplus or close-to-balance position" of public finance in 2001 and 2002. However, recent developments have been characterised by a relapse into deficit (1.2% and 1% of GDP in 2003 and 2004 respectively).

According to the update, real GDP growth is expected to pick up from annual rates of 1¾% in 2005 and 2006 to 2½% in 2008. Slower than previously assumed growth in 2005 and 2006, resulting in a widening of the negative output gap, is attributed to less buoyant international trade and higher oil prices. The pick up of economic activity in the outer years of the programme is expected on the back of growing investment and private consumption. Both the short-term and medium-term scenario is based on plausible growth assumptions. However, expectation of employment gains would appear somewhat optimistic. Inflation is expected to decline from 2.3% in 2005 to 1.5% in 2008, which seems plausible.

According to preliminary results, in 2005 the general government deficit amounted to 1.7% of GDP, which was 0.2 and 0.1 percentage point lower than planned in the updated programme and than forecasted by the Commission services respectively. The better-than-planned result was due to more favourable-than-foreseen developments on the revenue side in spite of substantial tax cuts. The planned expenditure was also exceeded, however, by a smaller margin.

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[1] This technical analysis, which is based on information available up to 24 January 2006, accompanies the recommendation by the Commission for a Council opinion on the update of the stability programme, which the College adopted on 1 February 2006. It has been carried out by the staff of and under the responsibility of the Directorate-General for Economic and Financial Affairs of the European Commission. Comments should be sent to Monika Sherwood (monika.sherwood@cec.eu.int). The analysis takes into account (i) the Commission services' autumn 2005 forecast, (ii) the code of conduct (Opinion of the Economic and Financial Committee on the "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005), (iii) the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances and (iv) the broad economic policy guidelines for the period 2005-2008.

[2] It provides all compulsory and most optional data prescribed by the latter. A minor gap is the missing calculation of tax burden in Table 2.

The programme describes the budgetary strategy as "three-pronged". First, it aims at a balanced budget over the economic cycle. Second, the strategy foresees a decline in the tax burden to below 40% of GDP by 2010. Third, it envisages raising potential growth by fostering investment in research, education and infrastructure. The update foresees a decline in the general government deficit from 1.9% of GDP in 2005 to 0% in 2008. The fiscal adjustment towards a balanced budget is back-loaded, with only a minor improvement in 2006, followed by two relatively more substantial steps. The profile of the primary surplus is similar. It is expected to rise from 1.1% of GDP in 2005 to 2.7% at the end of the period. Since revenue is expected to fall by 0.9 percentage point of GDP over the period 2005-2008, the planned consolidation is planned to be achieved via expenditure cuts, with the expenditure-to-GDP ratio dropping by 2.8 percentage points. The bulk of the retrenchment on the expenditure side is projected to fall on the categories "other primary expenditure" and "social transfers". Compared with the previous programme, the new update broadly confirms the planned adjustment against however a less favourable macroeconomic scenario.

The structural balance (in cyclically-adjusted terms and net of one-off and other temporary measures) is planned to improve on average by around ½ percentage point of GDP per year against the background of negative output gap throughout the period. The programme sets the medium-term objective (MTO) for the budgetary position as meant in the Stability and Growth Pact at 0% of GDP in structural terms and aims at achieving this position by 2008. As the programme's MTO is more demanding than the minimum benchmark (estimated at a deficit of around 1½% of GDP), its achievement should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. As regards appropriateness, the programme's MTO lies within the range indicated for euro area and ERM II Member States in the Stability and Growth Pact and the code of conduct and is more demanding than implied by the debt ratio and average potential output growth in the long term.

The budgetary path projected in the update seems plausible for the years 2005 and 2006, when it is based on legislated measures, notably the tax cuts. The consolidation in 2007 and 2008 does not seem fully substantiated by the policy measures discussed in the update. Moreover, the credibility of the projected improvement relies largely on the effectiveness of the Austrian National Stability Pact. Experience with previous pacts offers only limited help in determining whether the targets will be respected. The implementation of envisaged expenditure targets remains the main risk to the budgetary strategy, as has been stressed already in the assessments of previous updates.

In view of this risk assessment, the budgetary stance in the programme may not be sufficient to ensure that the programme's MTO is achieved by 2008. However, as stated above, the programme's MTO is more demanding than required by the Stability and Growth Pact. The budgetary strategy, if implemented as specified in the programme, seems adequate to achieve a budgetary position in structural terms that can be considered as appropriate under the Pact by the end of the programme period. In addition, the budgetary stance in the programme seems to provide a sufficient safety margin against breaching the 3% of GDP deficit ceiling with normal cyclical fluctuations throughout the programme period. The pace of the adjustment towards the programme's MTO implied by the programme is fully in line with the Stability and Growth Pact, which specifies that, for euro area and ERM II Member States, the annual improvement in the structural balance should be 0.5% of GDP as a benchmark and that the adjustment should be higher in good economic times and could be lower in bad economic times. While the Commission services are expecting this adjustment to be slower than foreseen in the

programme, it would still be compatible with the requirements of the Pact, given the existence of a negative output gap throughout the programme period.

The debt ratio is estimated to have reached 63.4% of GDP in 2005, thus slightly above the 60% of GDP Treaty reference value. The programme projects a decline in the debt ratio of 3.9 percentage points over the programme period, thereby returning below the reference value. The contribution from the primary balance is set to increase substantially over the programme period, while those from interest payments and nominal GDP growth are expected to remain largely unchanged. The risks to the projected evolution of the debt ratio appear to be broadly balanced. On the one hand, higher-than-targeted deficits could endanger adherence to the adjustment path presented in the programme. On the other hand, the update does not include the potential of privatisation in Austria. In view of this risk assessment, the debt ratio seems to be sufficiently diminishing towards the reference value.

With regard to the sustainability of public finances, Austria appears to be at low risk on grounds of the projected budgetary costs of ageing populations. The level of debt, currently above 60% of GDP, is projected to fall and remain below the reference value up to 2050 on the assumption that the planned budgetary consolidation is implemented. Austria's recent pension reform should contribute significantly to the containment of future increases in public expenditure. However, the structural deficit in the government finances, if not corrected, could pose a risk to public finance sustainability. Implementing the planned consolidation of public finances over the medium-term is therefore instrumental for reducing the risks to public finance sustainability.

The envisaged measures in the area of public finances are broadly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008. In particular, the measures are in line with the guidelines recommending safeguarding economic and fiscal sustainability and promoting an efficient allocation of resources geared towards higher growth and employment. However, the downside risks to the future budgetary developments could make the achievement of the country's medium-term objective more difficult to obtain.

The National Reform Programme of Austria, submitted on 19 October 2005 in the context of the renewed Lisbon strategy for growth and jobs, identifies the achievement of sustainable public finances as one of the key challenges for Austria. However, it does not spell out future measures envisaged towards meeting this challenge. In that respect, the stability programme is more detailed, providing information on some of the measures that are to contribute to the consolidation of public finances. The budgetary implications of the actions in the microeconomic and employment areas outlined in the National Reform Programme are broadly reflected in the budgetary projections of the stability programme. The latter outlines measures aimed at making the public administration and the health care system more efficient. It complements these with proposals for changes in the institutional features of the public finances, namely two comprehensive reforms of the legislation governing the budgetary process in Austria, which consist in the introduction of the medium-term budgetary framework from 2007 and shifting from input-dominated to objective-driven budgets from 2011. These measures are in line with the priorities laid out in the National Reform Programme.

In view of the above assessment, the ambitious structural adjustment planned over the programme period can be welcomed. However, Austria should make sure that the programme's MTO is achieved by the end of the update period by further specifying and

implementing measures that will support the budgetary consolidation planned for the two final years of the programme.

Comparison of key macroeconomic and budgetary projections

		2004	2005	2006	2007	2008
Real GDP (% change)	**SP Nov 2005**	**2.4**	**1.7**	**1.8**	**2.4**	**2.5**
	COM Nov 2005	2.4	1.7	1.9	2.2	n.a.
	SP Nov 2004	*1.9*	*2.5*	*2.5*	*2.2*	*2.4*
HICP inflation (%)	**SP Nov 2005**	**2.0**	**2.3**	**2.1**	**1.7**	**1.5**
	COM Nov 2005	2.0	2.2	2.1	1.7	n.a.
	SP Nov 2004	*2.1*	*1.8*	*1.4*	*1.5*	*1.6*
Output gap (% of potential GDP)	**SP Nov 2005**[1]	**-0.2**	**-0.7**	**-1.1**	**-0.9**	**-0.5**
	COM Nov 2005*[3]*	-0.2	-0.7	-1.0	-0.9	n.a.
	SP Nov 2004[1]	*-1.3*	*-0.8*	*-0.4*	*-0.1*	*0.2*
General government balance (% of GDP)	**SP Nov 2005**	**-1.0**	**-1.9**	**-1.7**	**-0.8**	**0.0**
	COM Nov 2005[2]	-1.0	-1.8	-1.8	-1.4	n.a.
	SP Nov 2004	*-1.3*	*-1.9*	*-1.7*	*-0.8*	*0.0*
Primary balance (% of GDP)	**SP Nov 2005**	**2.1**	**1.1**	**1.2**	**2.0**	**2.7**
	COM Nov 2005	1.9	1.0	1.0	1.4	n.a.
	SP Nov 2004	*1.9*	*1.2*	*1.3*	*2.2*	*2.9*
Cyclically-adjusted balance = structural balance (% of GDP)	**SP Nov 2005**[1]	**-0.9**	**-1.6**	**-1.2**	**-0.4**	**0.2**
	COM Nov 2005	-0.9	-1.5	-1.3	-1.0	n.a.
	SP Nov 2004[1]	*-0.9*	*-1.7*	*-1.6*	*-0.8*	*-0.1*
Government gross debt (% of GDP)	**SP Nov 2005**	**63.6**	**63.4**	**63.1**	**61.6**	**59.5**
	COM Nov 2005[2]	63.7	63.6	63.5	62.8	n.a.
	SP Nov 2004	*64.2*	*63.6*	*63.1*	*61.6*	*59.1*

Notes:
[1]Commission services calculations on the basis of the information in the programme
[2] Commission services' autumn 2005 forecast projections for the deficit and debt ratios have been adjusted to be comparable with the projections in the stability programme by recalculating the ratios on the basis of the new GDP series.
[3]Based on estimated potential growth of 1.9%, 2.2%, 2.2% and 2.1% respectively in the period 2004-2007.

Source:
Stability programme (SP); Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations

1. INTRODUCTION

The Austrian Council of Ministers adopted the update of the Austrian stability programme on 29 November 2005 and submitted it to the European Commission on the next day. The English version of the update was delivered on 6 December 2005. The update covers the period from 2005 to 2008. It has been sent to the Austrian Parliament for information and has also been made available to the general public.

The programme broadly follows the model structure and data provision requirements for stability and convergence programmes specified in the new code of conduct. It provides all compulsory and most optional data prescribed by the latter. A minor gap is the missing calculation of tax burden in Table 2. Annex 2 provides a detailed overview of all aspects of compliance with the new code of conduct.

2. ECONOMIC OUTLOOK

In the last decade the Austrian economy grew on average by 2.2% per year in real terms, matching the growth rate for the euro-zone as a whole. Austria's HICP inflation amounted to 1.5% on average, falling below the euro-zone's rate throughout this period. While employment growth has been much slower in Austria than in the rest of the euro-area, Austria has been enjoying one of the lowest unemployment rates in the whole EU. This can be partly attributed to the fact that Austria's labour force participation rate for older workers is one of the lowest in the EU.

The updated programme expects GDP growth to pick up from 1¾% in 2005 and 2006 to 2½% in the outer years. It cites slow growth of international trade and pressures stemming from rising oil prices as main reasons for the subdued growth rates in 2005 and 2006. From 2007, investment is expected to pick up, gradually feeding through to stronger private consumption, which should finally respond to the substantial personal income tax cuts. Net exports are supposed to provide a positive contribution to growth throughout the update period. The output gap is expected to remain negative throughout the programme period.

Up until 2007, the macroeconomic scenario in the programme is broadly in line with the Commission services' autumn 2005 forecast. However, there are some differences, one of them being the composition of aggregate demand. The programme relies a little bit less on the net exports contribution in 2005 and a bit more in 2006 and 2007 than the Commission services in their forecast. As regards its projections for private consumption growth, the update is slightly more optimistic for 2005 and 2006 and less optimistic for 2007 than the Commission services. Concerning the growth of wages and salaries, the Commission services predict a slower pace throughout the forecast period.

In 2008 (beyond the horizon of the Commission services' forecast) the predicted real GDP growth for that year is somewhat higher than the average potential growth in the 2005-2007 period calculated by the Commission services. However, since real GDP growth is expected to be below potential in 2005 and 2006, the prediction for 2008 does not seem excessively optimistic. Thus, all in all, the update is based on plausible growth assumptions.

There are a number of discrepancies between the external assumptions underlying the programme (which the Austrian authorities submitted separately) and the Commission services' forecast. In particular, in 2005 and 2006 monetary conditions are assumed to be somewhat looser, notwithstanding the higher oil price assumptions. Most of those differences are due to the fact that for the years 2005-2006, the update is based on a forecast prepared by the Austrian Institute of Economic Research (WIFO) at the end of September 2005.

Inflation developments presented in the programme are in line with the Commission services' autumn forecast. Expected wage and productivity developments are consistent with subdued inflationary pressure.

Table 1: Comparison of macroeconomic developments and forecasts

	2005		2006		2007		2008
	COM	SP	COM	SP	COM	SP	SP
Real GDP (% change)	1.7	1.7	1.9	1.8	2.2	2.4	2.5
Contributions:							
- Final domestic demand	0.9	1.0	1.6	1.5	1.9	2.0	2.0
- Change in inventories	-0.1	-0.1	0.1	-0.1	0.1	0.0	-0.1
- External balance on g&s	1.1	0.9	0.3	0.4	0.3	0.4	0.6
Output gap[1]	-0.7	-0.7	-1.0	-1.1	-0.9	-0.9	-0.5
Employment (% change)[2]	0.4	1.0	0.6	1.0	0.6	1.1	1.0
Unemployment rate (%)	5.0	5.2	5.0	5.1	5.1	5.0	4.9
Labour productivity growth (%)	1.3	0.7	1.3	0.8	1.6	1.3	1.5
HICP inflation (%)	2.2	2.3	2.1	2.1	1.7	1.7	1.5
GDP deflator (% change)	1.6	1.8	1.4	1.8	1.3	1.6	1.4
Compensation of employees (% change)	2.8	3.4	3.5	3.7	3.0	3.5	3.6
External balance (% of GDP)	0.7	0.5	0.4	0.4	0.5	0.5	0.6

Note:
[1]In percent of potential GDP, with potential GDP growth as reported in Table 2 below.

[2]The Commission predictions concerning employment growth are not comparable with that of the Stability Programme as the former are based on national accounts and the latter on social security data.

Source:
Commission services' autumn 2005 economic forecasts (COM); stability programme update (SP)

As presented in Table 2, the Commission services' calculations according to the commonly agreed methodology, based on the information provided in the programme, indicate potential output growth at 2.0 to 2 ¼%. These calculations of both the potential output growth and the output gaps are in line with Commission services' autumn forecast.

Table 2: Sources of potential output growth

	2005		2006		2007		2008
	COM	**SP²**	**COM**	**SP²**	**COM**	**SP²**	**SP²**
Potential GDP growth¹	2.2	2.2	2.2	2.2	2.1	2.1	2.1
Contributions:							
- Labour	0.6	0.6	0.5	0.6	0.4	0.4	0.3
- Capital accumulation	0.7	0.7	0.7	0.7	0.7	0.8	0.8
- TFP	1.0	0.9	1.0	0.9	1.0	1.0	1.1

Notes:
[1]Based on the production function method for calculating potential output growth
[2]Commission services' calculations on the basis of the information in the programme

Source:
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations

3. GENERAL GOVERNMENT BALANCE

This section is in four parts. The first briefly compares the targets for the general government balance in the new update with those presented in previous stability programmes. It also discusses budgetary implementation in the year 2005. The second part describes the budgetary strategy in the new update, including the programme's medium-term objective. The third provides the analysis of the risks attached to the budgetary targets and assesses the country's position in relation to the budgetary objectives of the Treaty and the Stability and Growth Pact. The final part discusses the results of a sensitivity analysis.

3.1. Targets in successive programmes and implementation in 2005

Table 3 and Figure 1 present the adjustment path envisaged in the programme as compared it with that in previous updates. The programme targets a balanced budget in 2008, starting from a general government balance of 1.9% of GDP in 2005. Apart from a better starting point with a somewhat lower deficit in 2004 than foreseen, there are no changes in terms of budgetary targets between the most recent update and that of November 2004. The targets have been confirmed in spite of a more subdued outlook for real GDP growth in 2005 and 2006 than in the previous update.

In terms of general government expenditure and revenue shares in GDP, the targets of the previous update were broadly respected in 2004 and 2005. However, both shares, while still on a downward trend, have been revised upward in the remaining part of the programme period, so that at the programme horizon, the discrepancy between the updates amounts to almost 1% of GDP for each of the ratios[3].

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[3]   Note that the revenue and expenditure shares in GDP are not fully comparable between the 2004 update and earlier updates due to methodological change in the calculation of GDP. In particular this involves the sectoral allocation of the financial intermediation services indirectly measured (FISIM). Following a Eurostat regulation, this new method is compulsory for all member states from 2005 on. Statistics Austria already introduced this change in October 2004. This change increases the level of nominal GDP by 1-2% for each year, so that comparisons of the planned adjustment paths between programme updates should be regarded with some caution. The impact on the deficit ratio is negligible, but the revenue and expenditure shares as well as the debt ratio are reduced.

The 2005 budget was affected by the new steps of the tax reform started one year earlier. The second stage, introduced in 2005, included the following: the personal income tax schedule was reduced to four brackets, including a zero tax bracket up to an income of € 15,800 for wage earners, € 13,600 for pensioners and € 10,000 for self-employed; the corporate tax rate was reduced from 34% to 25%; and tax rules for holdings (domestic and foreign) were simplified. The burden on the budget to be incurred by the reform in 2005 had been estimated at 0.8% of GDP, but tax revenue turned out to be higher than expected, mainly owing to higher proceeds from VAT and corporate tax. However, the planned expenditure was also exceeded (e.g. on education and family benefits), even though by a smaller margin. According to preliminary results announced by the government, the general government deficit amounted to 1.7% of GDP, which was 0.2 and 0.1 percentage point lower than planned in the updated programme and than forecasted by the Commission services respectively.

Table 3: Evolution of budgetary targets in successive programmes

		2004	2005	2006	2007	2008
General government balance (% of GDP)	**SP Nov 2005**	**-1.0**	**-1.9**	**-1.7**	**-0.8**	**0.0**
	SP Nov 2004	-1.3	-1.9	-1.7	-0.8	0.0
	SP Nov 2003	*-0.7*	*-1.5*	*-1.1*	*-0.4*	*n.a.*
	COM Nov 2005[1]	-1.0	-1.8	-1.8	-1.4	n.a.
General government expenditure (% of GDP)	**SP Nov 2005**	**49.8**	**49.5**	**48.5**	**47.6**	**46.7**
	SP Nov 2004	50.0	49.5	48.0	46.7	45.8
	SP Nov 2003	*50.7*	*50.0*	*49.4*	*48.4*	*n.a.*
	COM Nov 2005[1]	49.8	49.6	48.9	48.2	n.a.
General government revenues (% of GDP)	**SP Nov 2005**	**48.8**	**47.6**	**46.9**	**46.8**	**46.7**
	SP Nov 2004	48.7	47.5	46.2	46.0	45.8
	SP Nov 2003	*50.0*	*48.5*	*48.3*	*48.0*	*n.a.*
	COM Nov 2005[1]	48.8	47.6	47.0	46.7	n.a.
Real GDP (% change)	**SP Nov 2005**	**2.4**	**1.7**	**1.8**	**2.4**	**2.5**
	SP Nov 2004	1.9	2.5	2.5	2.2	2.4
	SP Nov 2003	*1.9*	*2.5*	*2.5*	*2.4*	*n.a.*
	COM Nov 2005	2.4	1.7	1.9	2.2	n.a.

[1] Commission services' autumn 2005 forecast projections for the deficit and debt ratios have been adjusted to be comparable with the projections in the stability programme by recalculating the ratios on the basis of the new GDP series.

Source:
Stability programmes (SP) and Commission services' autumn 2005 economic forecasts (COM)

Figure 1: General government balance projections in successive stability programmes (% of GDP)
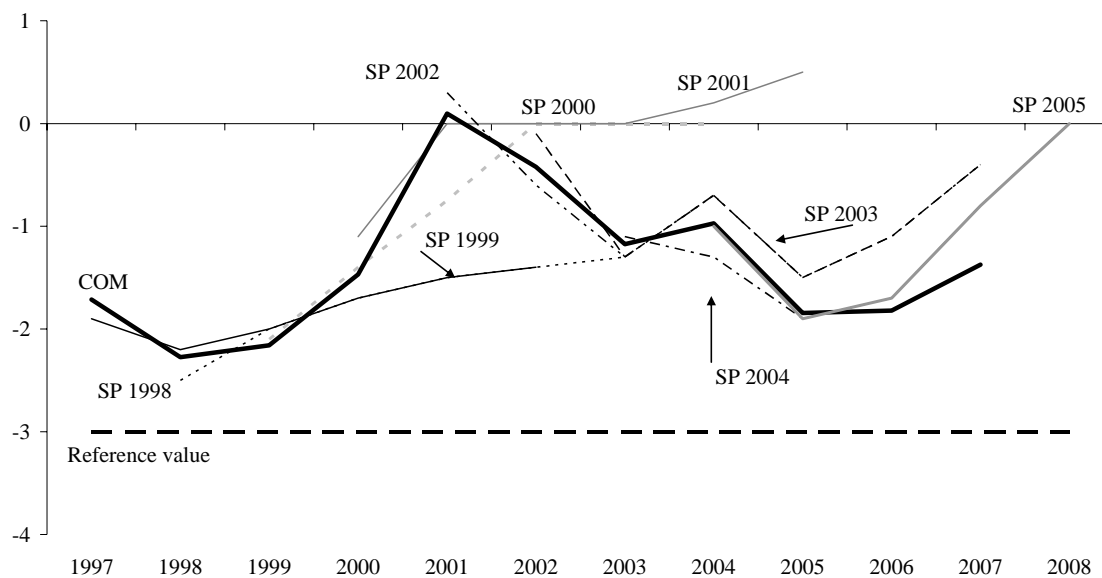
Source: Commission services' autumn 2005 forecast (COM) and successive stability programmes

3.2. The programme's medium-term budgetary strategy

This section covers in turn the following aspects of the medium-term budgetary strategy outlined in the programme: (i) the main goal of the budgetary strategy; (ii) the composition of the budgetary adjustment, including the broad measures envisaged; and (iii) the programme's medium-term objective and the adjustment path towards it in structural terms.

3.2.1. The main goal of the programme's budgetary strategy

The programme describes the budgetary strategy as "three-pronged". First, it aims at a balanced budget over the economic cycle. Second, the strategy foresees a decline in the tax burden to below 40% of GDP by 2010. Third, it envisages raising potential growth by fostering investment in research, education and infrastructure.

As presented in Table 4, the update foresees a decline in the general government deficit from 1.9% of GDP in 2005 to 0% in 2008. The profile of the planned fiscal adjustment is back-loaded, with only a minor improvement in 2006, followed by two relatively more substantial steps. The time profile of the primary surplus is similar, with an improvement from 1.1% in 2005 to 2.7% at the end of the period.

Compared with the previous programme, the new update broadly confirms the planned adjustment in spite of a less favourable macroeconomic scenario in 2005 and 2006.

Table 4: Composition of the budgetary adjustment

(% of GDP)	2004	2005	2006	2007	2008	Change: 2008-2005
Revenues*	48.8	47.6	46.9	46.8	46.7	**-0.9**
of which:						
- Taxes & social contributions	44.0	43.1	42.2	41.9	41.8	**-1.3**
- Other (residual)	4.9	4.7	4.7	4.9	5.1	**0.4**
Expenditure*	49.8	49.5	48.5	47.6	46.7	**-2.8**
of which:						
- Primary expenditure	46.7	46.5	45.6	44.8	44.0	**-2.5**
of which:						
Collective consumption	6.9	6.9	6.8	6.6	6.5	**-0.4**
Social transfers	30.0	30.0	29.7	29.5	29.2	**-0.8**
Subsidies	2.9	2.8	2.7	2.6	2.6	**-0.2**
Gross fixed capital formation	1.1	1.0	1.0	1.0	1.0	**0.0**
Other (residual)	5.8	5.9	5.4	5.1	4.8	**-1.1**
- Interest expenditure	3.1	3.0	2.9	2.8	2.7	**-0.3**
General government balance (GGB)	**-1.0**	**-1.9**	**-1.7**	**-0.8**	**0.0**	**1.9**
Primary balance	**2.1**	**1.1**	**1.2**	**2.0**	**2.7**	**1.6**
One-off and other temporary measures	0.0	0.0	0.0	0.0	0.0	0.0
GGB excl. one-off & other temporary measures	**-1.0**	**-1.9**	**-1.7**	**-0.8**	**0.0**	**1.9**
Source: *Stability programme update; Commission services' calculations,*Differences due to rounding*						

3.2.2. *The composition of the budgetary adjustment in the programme*

Since revenue is expected to fall by 0.9 pp. as a percentage of GDP over the period 2005-2008, the planned consolidation is going to rely on expenditure restraint, with the expenditure-to-GDP ratio dropping by 2.8 pp.

As presented in Table 4, about 40% (1.1 percentage points) of the planned expenditure reduction between 2005 and 2008 falls into the sub-category "other primary expenditure", which includes transfers such as contributions to the EU and capital transfers such as tax subsidies to households to promote fully-funded pension schemes. Since no detailed information on this reduction is provided in the programme, it is difficult to assess its plausibility. It is also worthwhile to note that in the previous update only 13% of the planned expenditure reduction between 2005 and 2008 was justified by savings in this category. This shows that more of the adjustment effort has been shifted between the most recent and the previous updates of the programmes towards this residual item, which is difficult to analyse.

According to the update, "social transfers" which comprise pensions, a part of spending on health care, unemployment benefits and education are supposed to contribute a 0.8 percentage point. reduction (29% of the total expenditure adjustment). As presented in Table 7 of the update, following the recent pension system reforms of 2003 and 2004, the pension-related expenditure share in GDP will decline by 0.5 percentage point between 2005 and 2010, i.e. by 0.1 percentage point per year on average. Therefore, one can assume that the pension-related expenditure share will decline by 0.3 percentage point by 2008. The measures concerning the public health system included in the fiscal revenue sharing agreement between the federal and sub-national governments (*Finanzausgleich*) of 2004 provide for some administrative reforms intended to lower health care

consumption leading to estimated cost savings of €300 million, i.e. about 0.12% of GDP annually until 2008. Unfortunately, health expenditure projections are not included in the update. Some easing in the social transfer expenditure ratio may be achieved by an improvement in the labour market foreseen by the authorities. However, the Commission services have a more sceptical view on that matter. The programme does not present projections concerning expenditure on education. All in all, further measures (or more detailed explanation of the already planned ones) seem necessary to achieve the envisaged reduction in the share of transfers in GDP.

The planned reduction of 0.4 percentage points in the sub-category "collective consumption" seems to be explained by the agreement on the further steps of the reform of public administration reached by the federal and sub-national government in November 2005. The agreement involves, among others, a reduction in the number of staff at all levels of government by 15,667 (full time equivalents) and therefore savings in the range of €1.9 billion (around 0.8% of GDP) by 2010.

Box 1: The budget for 2006

The budget for 2006 was prepared practically together with the 2005 budget, but for formal reasons it was only adopted on 7 April 2005. The budget targets a general government deficit of 1.7% of GDP in 2006.

On the revenue side, the 2006 budget will continue bearing the consequences of the 2004/2005 tax reform, which according to the calculations by Ministry of Finance will imply a 1.4% of GDP revenue loss for the budget. In fact, 2006 is the year in which the expected loss of revenue in terms of GDP due to the tax reform is the highest (0.1% in 2004; 0.8% in 2005 and 1.2% in 2007). One of the question marks on the revenue side is the impact of the recently introduced comprehensive taxation of holding companies ("Gruppenbesteuerung"), which is difficult to forecast and could diminish the tax revenue by more than the planned 100 million euro.

In terms of expenditure, in September 2005 the government adopted a new "package", worth approximately 0.1% of GDP, which consist mainly of measures aimed at reducing youth unemployment and helping women re-enter the job market. The bulk of the cost of the package will be born by the 2006 budget with the rest being covered by the following year's budget.

In 2004, the different levels of government in Austria agreed on a new fiscal revenue sharing scheme and on a national stability pact, which allocated the adjustment path of the general government deficit to the different levels of government from 2005 to 2008. The update of the stability programme takes this allocation as given. The state governments collectively are committed to run budget surpluses, which increase slightly over the programme period.

3.2.3. The programme's medium-term objective (MTO) and the adjustment path in structural terms

According to the Stability and Growth Pact, stability and convergence programmes should present a medium-term objective (MTO) for the budgetary position. The MTO should be differentiated for individual Member States, to take into account the diversity of economic and budgetary positions and developments as well as of fiscal risk to the sustainability of public finances. The country-specific MTO is defined in structural terms (i.e. cyclically-adjusted, net of one-off and other temporary measures) and should fulfil a triple aim, namely (i) provide a safety margin with respect to the 3% of GDP deficit

limit; (ii) ensure rapid progress towards sustainability; and (iii), taking (i) and (ii) into account, allow room for budgetary manoeuvre, considering in particular the needs for public investment. The code of conduct (Section I thereof) further specifies that, as long as the methodology for incorporating implicit liabilities is not fully developed and agreed by the Council, the country-specific MTOs are set taking into account the current government debt ratio and potential growth (in a long-term perspective), while preserving a sufficient margin against breaching the deficit reference value of 3% of GDP. Member States are free to set an MTO that is more demanding than strictly required to achieve the triple aim of MTOs.

The update of the Austrian stability programme sets an MTO of a balanced budget (0% of GDP), which it aims to achieve by the end of the programme period. Based on Commission services' calculations on the basis of the programme according to the commonly agreed methodology, the structural balance of about -1½% of GDP in 2005 is supposed to improve to +0.2% of GDP by the end of the programme period and hence, respect the programme's MTO. As presented in Table 5, the structural balance is planned to improve on average by around ½ percentage point of GDP per year. The consolidation effort is back-loaded, with most of the improvement planned to take place in the last two years of the programme period. The fiscal effort described in the programme is planned against the background of negative output gaps throughout the period covered.

Table 5: Output gaps, cyclically-adjusted and structural balances

% of GDP	2004		2005		2006		2007		2008	Change: 2008-2005
	COM	SP[1]	COM	SP[1]	COM	SP[1]	COM	SP[1]	SP[1]	SP[1]
Gen. gov't balance	-1.0	-1.0	-1.8	-1.9	-1.8	-1.7	-1.4	-0.8	0.0	1.9
One-offs[2]	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Output gap[3]	-0.2	-0.2	-0.7	-0.7	-1.0	-1.1	-0.9	-0.9	-0.5	0.2
CAB[4]=Structural balance[5]	-0.9	-0.9	-1.5	-1.6	-1.3	-1.2	-1.0	-0.4	0.2	1.8
change in CAB= change in struct. bal.	-0.1	-0.1	-0.6	-0.7	0.2	0.4	0.3	0.8	0.6	1.3
CAPB[4] = Struct. prim. bal.[6]	2.0	2.0	1.4	1.4	1.5	1.7	1.8	2.4	2.9	1.5

Notes:
[1]Output gaps and cyclical adjustment according to the stability programme (SP) as recalculated by Commission services on the basis of the information in the programme
[2]One-off and other temporary measures
[3]In percent of potential GDP. See Table 1 above.
[4]CAB = cyclically-adjusted balance; CAPB = cyclically-adjusted primary balance[5]CAB excluding one-off and other temporary measures
[6]Structural primary balance = CAPB excluding one-off and other temporary measures

Source:
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations

3.3. Assessment

This assessment is in three parts. The first assesses the appropriateness of the programme's medium-term objective. The second analyses risks attached to the budgetary targets and the third examines whether the budgetary strategy laid down in the programme is consistent with the budgetary objectives of the Treaty and the Stability and Growth Pact.

3.3.1. Appropriateness of the programme's medium-term objective

As the programme's MTO is more demanding than the minimum benchmark (estimated at a deficit of around 1½% of GDP), its achievement should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. As regards appropriateness, the programme's MTO lies within the range indicated for euro area and ERM II Member States in the Stability and Growth Pact and the code of conduct and is more demanding than implied by the debt ratio and average potential output growth in the long term.

3.3.2. Risks attached to the budgetary targets

The budgetary path projected in the update seems plausible only for the years 2005 and 2006, when it is based on legislated measures. The consolidation in 2007 and 2008 does not seem fully substantiated by the policy measures discussed in the update. The incomplete implementation of envisaged expenditure targets remains the main risk to the budgetary strategy, as has been stressed already in the assessments of previous updates.

The credibility of the improvement projected in the update relies heavily on the effectiveness of the third National Stability Pact (NSP) concluded for the years 2005-2008. The pact contains a monitoring and sanctioning mechanism in case various levels of government do not respect its goals. The fact that Austria has legally enshrined ambitious budgetary commitments across these various levels of government remains a remarkable exception in the EU. However, the experience with the previous pacts offers only limited help in determining whether the successor's main target, the balanced budget by 2008, is backed up by strict enforcement. The NSP rules seem to provide some room for adjusting the statistics and invoking exceptional circumstances – without strict publication requirements – before the pact becomes binding. There have recently been speculations as to whether Styria, the federal state which up to now refused to ratify the new NSP, will be able to meet its targets already in 2006. Apart from that the programme assumes that all layers of government will respect the NSP's targets strictly in accordance with the current version of ESA 95 rules from 2007 on (in 2005 and 2006, ESA 95 as it was interpreted on 16 October 2000 applies). However, the governments of the federal states have been increasingly relying on establishing companies for the purpose of managing real estate, and selling public property to those companies (worth around 0.2% of GDP in 2004) as a way to ensure the respect of the NSP's targets. According to a decision by Eurostat of 31 January 2002, revenues from such operations do not reduce the deficit. If the Länder are not able to meet their NSP goals from 2007 without recourse to that technique, there is a risk that this will impact negatively on the general government balance.

There seem to be no risks emanating from the tax projections as the ones presented in the update are more cautious than the ones prepared by the Commission services in their autumn forecast (for comparison see Table 6)[4].

In a long-term perspective, Austria has quite a good track record in terms of avoiding unfunded expenditure overruns. On average for the years 1999-2004, the expenditure in nominal terms turned out to be 2.6% higher than planned in the budget laws, but this was matched by revenue higher by 2.8% than budgeted. It is also noteworthy that in the last

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[4]   The flow of revenue in 2005 suggests that the shortfall caused by the tax reform will be lower than foreseen.

two years, the general government deficit turned out lower than foreseen in the updated programmes submitted in those years. However, in some instances Austria's adherence to the goals set in the previous updates of the stability programme provides mixed evidence, so it cannot be excluded that once again the programme's goals will not be achieved.

On top of the above-mentioned problems, the respect of the budgetary targets presented in the update may be endangered by the fact that the next national parliamentary elections are planned for autumn 2006 and that there are some risks that the adopted strategy may not be further pursued thereafter. However, it must be stressed that the new NSP will continue to be binding till the end of 2008, which means that the budgetary targets for the sub-national government levels will stay unchanged.

Table 6: Assessment of tax projections

	2006		2007		2008	p.m.:
	COM	**SP**	**COM[2]**	**SP**	**SP**	**OECD[1]**
Total taxes Change in tax-to-GDP ratio	-0.4	-0.8	0.3	-0.9	0.0	/
Difference	-0.4		-1.2		/	/
of which[3]: - elasticity component	-0.4		-1.2		/	/
- composition component	0.0		0.2		/	/
p.m. Observed elasticity to GDP	0.7	0.5	1.2	0.4	0.8	1.0

Notes:
[1]OECD ex-ante elasticity relative to GDP
[2]On a no-policy change basis
[3]The decomposition is explained in Annex 4

Source:
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)

In view of the arguments presented above, one can conclude that the achievement of the targets laid down in the programme, especially those for the two final years, is far from certain.

3.3.3. Compliance with the budgetary requirements of the Treaty and the Stability and Growth Pact

Taking into account the risk assessment above, the budgetary strategy outlined in the programme does not seem sufficient to ensure that the programme's MTO will be reached by the end of the programme period. Some additional adjustment effort would be needed to eliminate the downward risk. Nevertheless, even taking into account risks to the projections and given that the MTO is more demanding than necessary, the budgetary strategy seems adequate to achieve a budgetary position in structural terms that can be considered as appropriate under the Pact by the end of the programme period. There is a

sufficient safety margin against breaching the 3% of GDP threshold for the deficit with normal cyclical fluctuations almost throughout the programme period[5].

The adjustment path towards the programme's MTO as presented in the programme is appropriate. According to the recalculation of the Commission services on the basis of the information in the programme, the average annual adjustment in the period from 2005 to 2008 amounts to 0.6% of GDP in structurally-adjusted terms, which is in line with the 0.5% of GDP benchmark set in the Stability and Growth Pact. However, the improvement is not evenly spread over time. The adjustment in 2007 is twice as high as in 2006. According to the Commission services', the average annual adjustment may turn out to be closer to 0.4% of GDP. Even this slower adjustment would be compatible with the requirements of the Pact, especially in the face of a negative output gap throughout the programme period.

At face value, the strategy for the general government balance outlined in the programme is consistent with the broad economic policy guidelines in the area of public finances. However, the downside risks to the future budgetary developments could endanger adherence to the country's medium-term objective, the respect of which is called for in Integrated Guideline 1.

3.4. Sensitivity analysis

The programme contains the following three alternative scenarios to the one presented as the baseline throughout the update: 1) permanent oil price shock and slower growth of the world economy, 2) slower growth of the world economy and lower interest rates, 3) faster growth of world economy and higher interest rates[6]. Scenarios 1 and 2 imply that the achievement of a balanced general government budget is postponed beyond 2008. In contrast, scenario 3 assumes that a balance position would be attained one year earlier.

The Commission services' simulations of the cyclically-adjusted balance under the assumptions of (i) a sustained 0.5 percentage point deviation from the real GDP growth projections in the programme over the 2005-2008 period; (ii) trend output based on the HP-filter[7] and (iii) no policy response (notably, the expenditure level is as in the central scenario[8]), reveal that, by 2008, the cyclically-adjusted balance is about 0.5 percentage point of GDP above/below the central scenario. Hence, in the case of persistently lower

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[5]   Theoretically, since the cyclically-adjusted budget deficit (recalculated by the Commission services on the basis of the information in the programme) at 1.6% of GDP in 2005 surpasses the minimum benchmark for Austria set at 1.5% of GDP, there could be a slight danger of breaching the above-mentioned threshold. However, given the current budgetary situation of Austria such a danger is miniscule.

[6]   None of them indicates how revenues and expenditures would react to variations in economic variables (as required by the new code of conduct). However, upon request the Austrian authorities provided more information enabling such calculations.

[7]   In the absence of a fully-specified macroeconomic scenario that would underlie such deviations, it is obviously impossible to derive new estimates of potential growth from the agreed production function method.

[8]   The effect of lower/higher growth on revenues is captured by using the conventional sensitivity parameters adopted in cyclical adjustment procedures.

real growth, some additional measures would be necessary to keep the public finances on the path targeted in the central scenario.[9]

4. GENERAL GOVERNMENT GROSS DEBT

This section is in two parts: the first describes the debt path envisaged in the programme and the second contains the assessment.

4.1. Debt developments in the programme

In 2005, the debt to GDP ratio is expected to turn out slightly lower than assumed in the previous update. The programme expects the debt ratio to fall below the 60% reference value in 2008, which is in line with the previous update. However, the planned reduction of 3.9 percentage points between 2005 and 2008 is less ambitious than the 4.5 percentage points foreseen for the same period in the previous update. To a large extent, this change can be explained by lower primary balances. Nevertheless, the primary surplus is expected to grow over the programme period. Contributions from interest payments and nominal GDP will not change much over the programme period.

Figure 2: Debt projections in successive stability programmes (% of GDP)
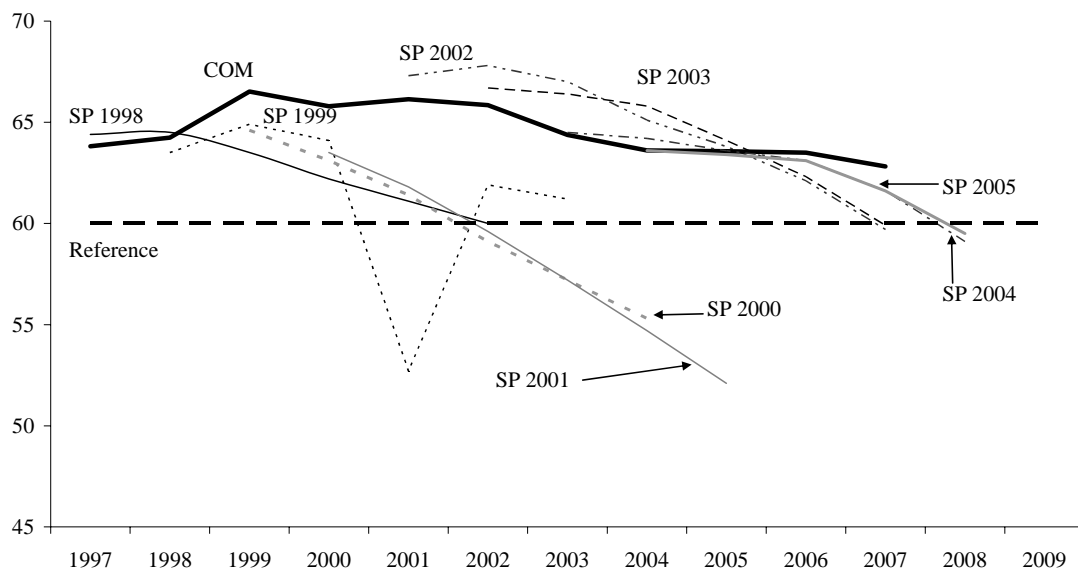
Source : Commission services' autumn 2005 forecast (COM) and successive stability programmes

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[9] Unexpected changes in inflation are not assumed to affect the expenditure-to-GDP ratio as nominal expenditure should broadly move in lockstep with the price level.

Table 7: Debt dynamics

	average 2000-2004	2005		2006		2007		2008
	COM	COM	SP	COM	SP	COM	SP	SP
Government gross debt ratio	**65.2**	63.6	63.4	63.5	63.1	62.8	61.6	59.5
Change in debt ratio (1 = 2+3+4)	-0.6	0.0	-0.2	-0.1	-0.3	-0.7	-1.5	-2.1
Contributions:								
- **Primary balance** (2)	**-2.4**	**-1.0**	**-1.1**	**-1.0**	**-1.2**	**-1.4**	**-2.0**	**-2.7**
- **"Snow-ball" effect** (3)	**1.0**	**0.8**	**0.9**	**0.8**	**0.6**	**0.6**	**0.4**	**0.4**
- Interest expenditure	3.2	2.9	3.0	2.8	2.9	2.8	2.8	2.7
- Real GDP growth	-1.1	-1.0	-1.0	-1.2	-1.1	-1.4	-1.5	-1.5
- Inflation (GDP deflator)	-1.1	-1.0	-1.1	-0.9	-1.2	-0.8	-1.0	-0.8
- **Stock-flow adjustment** (4)	**0.8**	**0.2**	**0.0**	**0.1**	**0.3**	**0.1**	**0.1**	**0.2**
- Cash/accruals	0.0							
- Accumulation of financial assets	1.1							
of which: Privatisation proceeds	-0.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0
- Valuation effects & residual adj.	-0.3							

Note:

The change in the gross debt ratio can be decomposed as follows:

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \left(\frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1 + y_t} \right) + \frac{SF_t}{Y_t}$$

where *t* is a time subscript; *D, PD, Y* and *SF* are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and *i* and *y* represent the average cost of debt and nominal GDP growth. The term in parentheses represents the "snow-ball" effect.

Source:
Stability programme update (SP); Commission services' autumn 2005 economic forecasts (COM);
Commission services' calculations

4.2. Assessment

The Commission services' autumn 2005 forecast and the programme foresee almost identical debt to GDP ratios (difference of 0.2 pp.) in 2005. However, the predictions of the former and the latter diverge gradually reaching difference of 1.2 percentage points in 2007. To a large extent the difference can be explained by the programme's much more optimistic outlook for the primary balance. One has to bear in mind, though, that the Commission services' forecast had been prepared before the different levels of government agreed on the next steps of the administrative reform, which could explain a part of the divergence. The risks to the projected evolution of the debt ratio appear to be broadly balanced. On the one hand, higher-than-targeted deficits could endanger adherence to the adjustment path presented in the programme. On the other hand, the update does not include potential privatisation receipts. In view of this risk assessment, the debt ratio seems to be sufficiently diminishing towards the reference value. In this respect, the debt reduction strategy in the update is consistent with the broad economic policy guidelines in the area of public finances.

Box 2: The rolling debt reduction benchmark

The debt ratio has been exceeding the 60% of GDP reference value since 1994. A tentative assessment of the pace of debt reduction over a medium-term horizon is presented in the accompanying graph. It shows historical data, the Commission services' autumn 2005 forecasts until 2007 (which are on a no-policy change scenario) and the multi-annual debt projections in the update and compares them with the paths obtained by applying an illustrative "rolling debt reduction benchmark" (see Annex 5). The benchmark reflects the idea that a minimum debt reduction should be ensured not year after year but over a medium-term horizon (five years in the graph). For instance, the debt projection for 2005 is compared with the value obtained for the same year by applying the formula starting in 2000. Debt level projections in the programme exceeding those obtained by applying the benchmark are taken as an indicator of a slow reduction in the debt ratio.

The graph shows that the planned reduction of the debt ratio in the update is more than implied by the five-year rolling debt reduction benchmark.

Austria: rolling five-year debt benchmark

Legend:
- projected debt ratio (programme)
- debt benchmark from 2000
- debt benchmark from 2001
- debt benchmark from 2002
- debt benchmark from 2003
- debt benchmark from 2004
- debt benchmark from 2005
- Commission services' autumn 2005 forecast
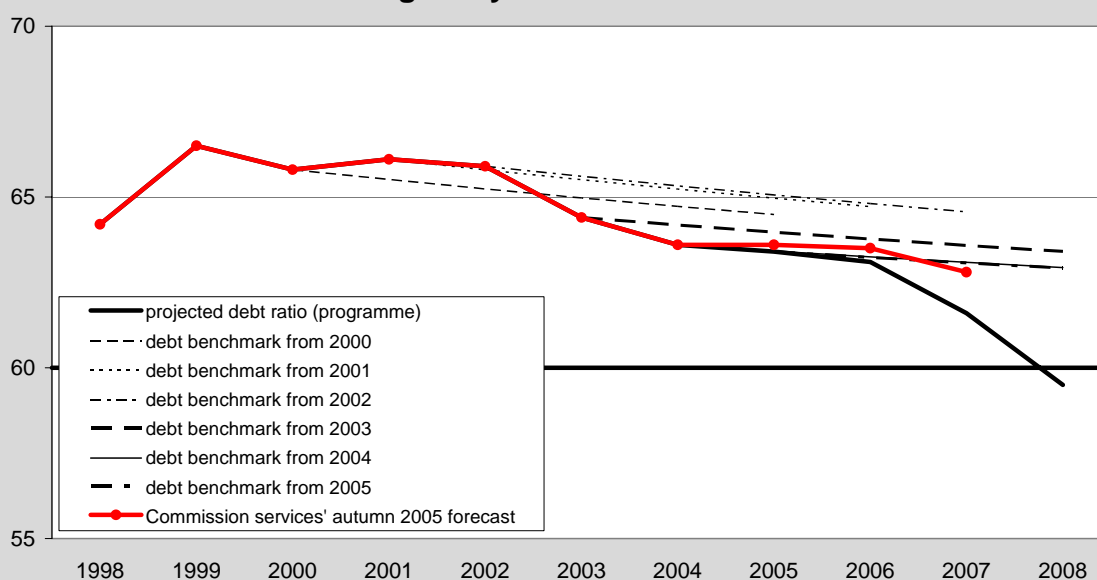
Source : Stability programme and Commission services

5. STRUCTURAL REFORM, THE QUALITY OF PUBLIC FINANCES AND INSTITUTIONAL FEATURES

The reform of public administration which has already led to a significant reduction in the number of federal civil servants is going to be continued and extended to other levels of government, which is expected to yield relatively substantial savings and therefore contribute to budgetary consolidation. However, it should be noted that the representatives of the various levels of government failed to find an agreement on the harmonisation of the pension entitlements of the sub-national governments' officials with the general pension scheme, which could have brought on even greater cost reduction.

In terms of the health care sector, the programme presents a package of measures that are supposed to result in saving of € 300 million on the expenditure side and additional revenue of € 300 million per year in the period 2005-2008. The expenditure-reducing measures consist mainly of raising the efficiency of the health care sector through e.g.

shorter hospital stays, lower administrative spending and better coordination between hospitals and practitioners. Regarding the additional revenue, the package foresees among others raising the health insurance contribution rate, an increase in the tobacco tax and a reduction in refunds for optical devices. It seems that the measures on the revenue side are defined in a much more concrete way than those impacting expenditure. Since the latter are presented in a very general manner, there is a doubt whether they will result in the above-mentioned additional saving.

The update also presents information on two planned comprehensive reforms of the legislation governing the budgetary process in Austria, which have the potential for contributing substantially to the consolidation of public finances (for more information please refer to Box 3). The first one consists in the introduction of the medium-term budgetary framework on 1 January 2007. The second one concerns the programming of expenditure, moving from input-oriented budgets to ones in which the allocation of budgetary resources is linked to measurable objectives from 1 January 2011. However, as commendable as it is to introduce such reforms, unfortunately there is no clear schedule for adoption of the reforms. Initially all the political parties represented in the Parliament had agreed to adopt the new law before summer 2005. Then, for political reasons, this decision was reversed. At the moment (December 2005) the political parties are still debating which parliamentary committee should handle the issue, which could endanger the timely introduction of the medium-term budgetary framework planned for 1 January 2007.

Box 3: Reform of the budgetary law

Following international examples of best practice, the Austrian authorities started preparing a reform package which aims at creating a modern, objective-driven budgetary law. In practical terms, a draft constitutional amendment has been put together which would constitute a basis for the new budgetary framework on which additional legal steps would be elaborated. The planned reforms would only concern the federal government and not the sub-national governments.

The first element of the envisaged budgetary legislation reform package is the introduction of a medium term budgetary framework: According to the new rules, the Parliament will be obliged to adopt a four-year plan concerning expenditure limits in the main budgetary categories (such as justice and security, education, research and culture, etc.) and then roll it forward by one year every spring. However, expenditure ceilings will be divided into fixed and flexible ones. The latter will concern areas which rely heavily on cyclical fluctuations such as labour market allocations, pensions, family transfers, etc. The plan is for the new law to come into force on 1 January 2007.

The other part of the package is the idea to change the budgetary law so that it would be driven by outputs and not inputs as is the case currently. According to the proposed amendments, economic stability and sustainability of public finances should be an over-arching goal of budgetary policy. Performance budgeting, transparency, efficiency and accurate presentation of the financial situation by the federal government shall be guiding principles in the budgetary process. The provisions concerning the above-mentioned are supposed to come into force on 1 January 2011.

According to the update, once implemented the reforms could contribute to expenditure reduction in the range of 5% of the federal government budget expenditure.

The measures described above are consistent with the broad economic policy guidelines in the area of public finances. They are also in line with the National Reform

Programme, submitted on 19 October 2005 in the context of the renewed Lisbon strategy for growth and jobs. The NRP stated the achievement of sustainable public finances as one of the key challenges for Austria, but did not present any future measures aimed at reaching this goal. In this respect, the update of the stability programme is much more detailed providing information on the above-mentioned developments concerning the administration and budget law reforms as well as the health care sector. The budgetary projections in the programme broadly take into account the public finance implications of the actions envisaged in the NRP

6. THE SUSTAINABILITY OF THE PUBLIC FINANCES

The assessment of the sustainability of Austria's public finances is based on an overall judgement of the results of quantitative indicators and qualitative features. The debt projections and sustainability indicators are calculated according to two different scenarios, to take into account different budgetary developments over the medium term. The "programme" scenario assumes that the medium-term budgetary plans presented in the programme are actually achieved. The "2005" scenario assumes that the structural primary balance[10] remains unchanged at the 2005 level throughout the programme period.

The Austrian programme only included long-term projections of pension expenditure[11]. On the basis of this information, age-related expenditure is foreseen to increase by 0.9% of GDP between 2008 and 2050, to which health-care expenditures contribute the most by 1.2% of GDP (see Table A2 in the Annex).

The gross debt-to-GDP ratio is currently above the reference value of 60%. It is projected to decline over the coming two decades and thereafter rise above the reference value in the late 2020s in the '2005' scenario[12]. However, in the 'programme' scenario the debt-to-GDP ratio is projected to fall and remain below 60% of GDP throughout the projection period, highlighting the importance of achieving the budgetary consolidation in the medium-term as outlined in the update (see Table A4 in the Annex).

In the '2005' scenario, the sustainability gap (S1) that ensures a debt level at 60% of GDP in 2050 would be around ¼% of GDP. The government's inter-temporal budget constraint, captured by the S2 indicator, point to a sustainability gap of a similar magnitude. The estimated future budgetary impact of ageing is relatively low in an EU perspective, reflecting in particular the cost-saving reforms of the pension system that was introduced starting in 2003. However, the initial budgetary position is not sufficiently high to fully offset the future budgetary impact of ageing.

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[10] The primary balance where the effect of the cycle and any one-off or temporary measures have been netted out.

[11] The long-term projections of health-care and long-term care expenditure included in the 2004 stability programme were used in the analysis. In addition, the long-term projections for education and unemployment benefits made by the EPC in 2003 were included in the analysis. Other expenditure items and revenues are assumed to remain constant as a share of GDP over the projection period.

[12] It should be recalled that, being a mechanical, partial equilibrium analysis, projections are in some cases bound to show highly accentuated profiles. As a consequence, the projected evolution of debt levels should not be seen as a forecast.

The budgetary consolidation over the programme period is consistent with reducing risks to public finance sustainability. Indeed, in the programme scenario the sustainability gaps, measured either by the S1 or S2 indicator are eliminated, indicating that the budgetary challenge posed by ageing populations can be dealt with by sticking to the medium-term budgetary plans as set down in the stability programme. This sustainability gap as measured by the S2 indicator translates into a required primary balance (RPB) of about 2% of GDP, lower than the structural primary balance of about 3% of GDP of the last year of the programme period[13].

Table 9: Sustainability indicators and the required primary balance

| | Sustainability indicators and RPB | | | | | | |
| | 2005 Scenario | | | Programme scenario | | |
	S1	S2	RPB	S1	S2	RPB
Value (of which)	**0.3**	**0.4**	**2.1**	**-1.2**	**-1.1**	**2.1**
initial budgetary position	*-0.6*	*-0.5*		*-2.1*	*-2.1*	
debt requirement in 2050	*0.0*	*:*		*0.0*	*:*	
future changes in budgetary position	*0.9*	*0.9*		*0.9*	*0.9*	

Note: The S1 indicator shows the difference, the sustainability gap, between the constant revenue ratio as a share of GDP required to reach a debt ratio in 2050 of 60% of GDP and the current revenue ratio. The S2 indicator, which shows the difference, the sustainability gap, between the constant revenue ratio as a share of GDP that guarantees the respect of the inter-temporal budget constraint of the government, i.e. that equates the actualized flow of revenues and expenses over an infinite horizon, and the current revenue ratio[14]. The Required Primary Balance (RPB) measures the average primary balance over the first five years of the projection period that results from a permanent budgetary adjustment carried out to comply fully with the inter-temporal budget constraint. See the European Commission (2005), European Economy, 'Public finances in EMU – 2005', Section II.3 for a further description.

In interpreting these results, several factors need to be taken into account.

GDP growth is projected to be somewhat faster than the one underlying the long-term projections of age-related public spending carried out for the Economic Policy Committee up to the 2020s than in the programme and thereafter the reverse is projected, i.e. somewhat higher GDP growth in the latter part of the projections period in the Austrian update (see Table A1 in the Annex). The unemployment rate however is projected to be the same in the update as in the EPC projections. Overall, the underlying assumptions in the programme can therefore be considered to be plausible.

The set of comprehensive reforms of the Austrian pension system has been finalised with the harmonisation of previously existing various pension schemes for different groups of the population, coming into force on 1 January 2005. Thus, a single pension system for most segments of the population with equal rules governing contributions and benefits has been established. Civil servants of the federal government under the age of 50 are integrated into the new system.

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[13] Given that the sustainability gap is small for Austria in the period up to 2050, there is virtually no cost of a five-year delay in adjusting the budgetary position according to the S1 and S2 (see the sensitivity test in Table A3 in the Annex).

[14] The sustainability gap indicators (S1, S2) do not necessarily suggest that taxes should be increased; strengthening the fiscal position by permanently reducing the level of non-age related primary spending could be preferable and has the same impact.

It is noteworthy that the Austrian reformed pension system provides for a sustainability clause which foresees automatic adjustments of the contribution rate, accrual rate, retirement age, etc. in case of envisaged divergences from the medium-term scenario on which the pension projections are based. Overall, the reform of the Austrian pension system significantly contains future rises in age-related expenditure.

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Annex 1: Summary tables from the stability programme update

Table 1a. Macroeconomic prospects

	ESA Code	2004 Level	2004 rate of change	2005 rate of change	2006 rate of change	2007 rate of change	2008 rate of change
1. Real GDP	B1*g	232.5	2.4	1.7	1.8	2.4	2.5
2. Nominal GDP	B1*g	237.0	4.4	3.5	3.7	4.0	3.9
Components of real GDP							
3. Private consumption expenditure	P.3	129.5	0.8	1.4	1.7	1.9	2.0
4. Government consumption expenditure	P.3	41.5	1.0	0.7	0.1	0.8	0.8
5. Gross fixed capital formation	P.51	48.9	0.6	0.4	2.4	4.0	3.6
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	1.0	0.1	-0.1	-0.1	0.0	-0.1
7. Exports of goods and services	P.6	119.6	9.0	3.4	4.3	5.4	5.8
8. Imports of goods and services	P.7	108.0	6.2	1.8	3.9	5.1	5.2
Contributions to real GDP growth							
9. Final domestic demand		-	0.8	1.0	1.5	2.0	2.0
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	-	0.1	-0.1	-0.1	0.0	-0.1
11. External balance of goods and services	B.11	-	1.6	0.9	0.4	0.4	0.6

Table 1b. Price developments

	ESA Code	2004 level	2004 rate of change	2005 rate of change	2006 rate of change	2007 rate of change	2008 rate of change
1. GDP deflator			1.9	1.8	1.8	1.6	1.4
2. Private consumption deflator			2.0	2.4	2.1	1.7	1.4
3. HICP[15]		112.3	2.0	2.3	2.1	1.7	1.5
4. Public consumption deflator			1.9	2.1	2.5	1.7	1.7
5. Investment deflator			1.7	2.2	1.8	1.5	1.4
6. Export price deflator (goods and services)			1.0	1.5	1.0	1.0	0.9
7. Import price deflator (goods and services)			1.2	2.7	1.5	1.0	1.0

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15   Optional for Stability programmes.

Table 1c. Labour market developments

	ESA Code	2004 Level	2004 rate of change	2005 rate of change	2006 rate of change	2007 rate of change	2008 rate of change
1. Employment, persons[16]		3.451,963	0.7	1.0	1.0	1.1	1.0
2. Employment, hours worked[17]		6781.0	0.3	-	-	-	-
3. Unemployment rate (%)[18]			4.8	5.2	5.1	5.0	4.9
4. Labour productivity, persons [19]		67353.0	1.7	0.7	0.8	1.3	1.5
5. Labour productivity, hours worked[20]		34.3	2.2	-	-	-	-
6. Compensation of employees	D.1	116.6	2.5	3.4	3.7	3.5	3.6

Table 1d. Sectoral balances

% of GDP	ESA Code	2004	2005	2006	2007	2008
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	0.3	0.5	0.4	0.5	0.6
of which: - Balance on goods and services		2.0	2.2	2.2	2.4	2.6
- Balance of primary incomes and transfers		-1.7	-1.7	-1.7	-1.9	-2.0
- Capital account		0.4	-0.5	-0.4	-0.5	-0.5
2. Net lending/borrowing of the private sector	B.9/ EDP B.9	2.0	2.4	2.1	1.3	0.6
3. Net lending/borrowing of general government	B.9	-1.0	-1.9	-1.7	-0.8	0.0
4. Statistical discrepancy		-0.7	0.0	0.0	0.0	0.0

Table 2. General government budgetary prospects

	ESA code	2004 Level	2004 % of GDP	2005 % of GDP	2006 % of GDP	2007 % of GDP	2008 % of GDP
				Net lending (EDP B.9) by sub-sector			
1. General government	S.13	-2.3	-1.0	-1.9	-1.7	-0.8	0.0
2. Central government	S.1311	-3.3	-1.4	-2.4	-2.2	-1.4	-0.8
3. State government	S.1312	0.7	0.3	0.4	0.4	0.6	0.6
4. Local government	S.1313	0.4	0.2	0.3	0.2	0.2	0.2

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[16] Figure for 2004: occupied population, domestic concept national accounts definition, full-time equivalents; growth rates 2004-2008: change in economically active persons (social security data, dependent and self-employed without persons on parental leave, without persons in the military/civil service)

[17] National accounts definition.

[18] Harmonised definition, Eurostat; levels.

[19] Real GDP per person employed.

[20] Real GDP per hour worked.

5. Social security funds	S.1314	-0.1	0.0	-0.1	-0.1	-0.1	0.0

General government (S13)							
6. Total revenue	TR	115.7	48.8	47.6	46.9	46.8	46.7
7. Total expenditure	TE[21]	118	49.8	49.5	48.5	47.6	46.7
8. Net lending/borrowing	EDP B.9	-2.3	-1.0	-1.9	-1.7	-0.8	0.0
9. Interest expenditure (incl. FISIM)	EDP D.41 incl. FISIM	7.3	3.1	3.0	2.9	2.8	2.7
pm: 9a. FISIM		0.3	0.1	0.1	0.1	0.1	0.1
10. Primary balance	[22]	5.0	2.1	1.1	1.2	2.0	2.7

Selected components of revenue							
11. Total taxes (11=11a+11b+11c)		66.1	27.9	27.1	26.3	26.1	26
11a. Taxes on production and imports	D.2	34.3	14.5	14.3	14.1	14.0	13.9
11b. Current taxes on income, wealth, etc	D.5	31.6	13.3	12.8	12.2	12.1	12
11c. Capital taxes	D.91	0.2	0.1	0.1	0.1	0.1	0.1
12. Social contributions	D.61	38.1	16.1	16.0	15.9	15.8	15.8
13. Property income	D.4	3.2	1.4	1.2	1.2	1.3	1.4
14. Other (14=15-(11+12+13))		8.3	3.5	3.5	3.5	3.6	3.7
15=6. Total revenue	TR	115.7	48.8	47.6	46.9	46.8	46.7
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)[23]							

Selected components of expenditure							
16. Collective consumption	P.32	16.5	6.9	6.9	6.8	6.6	6.5
17. Total social transfers	D.62 + D.63	71.3	30.0	30.0	29.7	29.5	29.2
17a. Social transfers in kind	P.31 =D.63	26.0	10.9	10.9	10.8	10.7	10.6
17b. Social transfers other than in kind	D.62	45.4	19.1	19.1	18.9	18.8	18.6
18.=9. Interest expenditure (incl. FISIM)	EDP D.41 incl. FISIM	7.3	3.1	3.0	2.9	2.8	2.7
19. Subsidies	D.3	6.9	2.9	2.8	2.7	2.6	2.6
20. Gross fixed capital formation	P.51	2.5	1.1	1.0	1.0	1.0	1.0
21. Other (21=22-(16+17+18+19+20))		13.7	5.8	5.9	5.4	5.1	4.8
22=7. Total expenditure	TE[24]	118	49.8	49.5	48.5	47.6	46.7
Pm: compensation of employees	D.1						

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[21] Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

[22] The primary balance is calculated as (EDP B.9, item 8) plus (EDP D.41 + FISIM recorded as intermediate consumption, item 9).

[23] Including those collected by the EU and including an adjustment for uncollected taxes and social contributions (D.995), if appropriate.

[24] Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

Table 3. General government expenditure by function

in billion €	COFOG Code	2003	2008
1. General public services	1	16.9	15.7
2. Defence	2	2.0	2.2
3. Public order and safety	3	3.2	3.8
4. Economic affairs	4	11.7	13.0
5. Environmental protection	5	0.9	1.2
6. Housing and community amenities	6	1.6	1.8
7. Health	7	14.9	18.1
8. Recreation, culture and religion	8	2.2	2.5
9. Education	9	13.1	16.1
10. Social protection	10	48.4	54.1
11. Total expenditure (= item 7=26 in Table 2)	TE[25]	**114.9**	**128.4**

Table 4. General government debt developments

% of GDP		2004	2005	2006	2007	2008
1. Gross debt[26]		63.6	63.4	63.1	61.6	59.5
2. Change in gross debt ratio		-0.8	-0.2	-0.3	-1.5	-2.1
Contributions to changes in gross debt						
3. Primary balance[27]		-2.1	-1.1	-1.2	-2.0	-2.7
4. Interest expenditure (incl. FISIM) [28]		3.1	3.0	2.9	2.8	2.7
5. Stock-flow adjustment		1.0	0.1	0.2	0.2	0.2
of which: - Differences between cash and accruals[29]						
- Net accumulation of financial assets[30] *of which:* *- privatisation proceeds*						
- Valuation effects and other[31]						
p.m. implicit interest rate on debt[32]		4.9	4.8	4.7	4.5	4.5
Other relevant variables						
6. Liquid financial assets[33]						
7. Net financial debt (7=1-6)						

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[25] Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

[26] As defined in Regulation 3605/93 (not an ESA concept).

[27] Cf. item 10 in Table 2.

[28] Cf. item 9 in Table 2.

[29] The differences concerning interest expenditure, other expenditure and revenue could be distinguished when relevant.

[30] Liquid assets, assets on third countries, government controlled enterprises and the difference between quoted and non-quoted assets could be distinguished when relevant.

[31] Changes due to exchange rate movements, and operation in secondary market could be distinguished when relevant.

[32] Proxied by interest expenditure (incl. FISIM recorded as consumption) divided by the debt level of the previous year.

[33] AF1, AF2, AF3 (consolidated at market value), AF5 (if quoted in stock exchange; including mutual fund shares).

Table 5. Cyclical developments

% of GDP	ESA Code	2004	2005	2006	2007	2008
1. Real GDP growth (%)		2.4	1.7	1.8	2.4	2.5
2. Net lending of general government	EDP B.9	-1.0	-1.9	-1.7	-0.8	0.0
3. Interest expenditure (incl. FISIM recorded as consumption)	EDPD. 41 + FISIM	3.1	3.0	2.9	2.8	2.7
4. Potential GDP growth (%) (1)		1.9	2.0	1.9	2.0	2.1
contributions:						
- labour		0.2	0.2	0.2	0.2	0.2
- capital		0.8	0.7	0.7	0.7	0.8
- total factor productivity		1.0	1.0	1.0	1.1	1.1
5. Output gap		-0.5	-0.7	-0.9	-0.5	-0.1
6. Cyclical budgetary component		-0.2	-0.4	-0.4	-0.2	0.0
7. Cyclically-adjusted balance (2-6)		-0.8	-1.5	-1.3	-0.5	0.0
8. Cyclically-adjusted primary balance (7-3)		2.3	1.5	1.6	2.3	2.7

(1) Until an agreement on the Production Function Method is reached, Member States can use their own figures (*SP*)

Table 6. Divergence from previous update

	ESA Code	2004	2005	2006	2007	2008
Real GDP growth (%)						
Previous update		1.9	2.5	2.5	2.2	2.4
Current update		2.4	1.7	1.8	2.4	2.5
Difference		0.5	-0.8	-0.7	0.2	0.1
General government net lending (% of GDP)	EDP B.9					
Previous update		-1.3	-1.9	-1.7	-0.8	0.0
Current update		-1.0	-1.9	-1.7	-0.8	0.0
Difference		0.3	0.0	0.0	0.0	0.0
General government gross debt (% of GDP)						
Previous update		64.2	63.6	63.1	61.6	59.1
Current update		63.6	63.4	63.1	61.6	59.5
Difference		-0.6	-0.2	0.0	0.0	0.4

Table 7. Long-term sustainability of public finances

% of GDP	2000	2005	2010	2020	2030	2050
Total expenditure						
Of which: age-related expenditures						
Pension expenditure		14.2	13.7	13.7	15.0	13.1
Social security pension		10.5	10.3	10.7	12.2	11.9
Old-age and early pensions		11.0	10.8	11.2	12.4	11.1
Other pensions (disability, survivors)		2.2	1.9	1.6	1.3	0.9
Occupational pensions (if in general government)						
Health care						
Long-term care *(this was earlier included in the health care)*						
Education expenditure						
Other age-related expenditures						
Interest expenditure						
Total revenue						
Of which: property income						
of which: from pensions contributions (or social contributions if appropriate)		8.2	8.3	8.2	8	7.9
Pension reserve fund assets						
Of which: consolidated public pension fund assets (assets other than government liabilities)						
Assumptions						
Labour productivity growth		1.5	1.8	1.8	1.7	1.7
Real GDP growth		1.9	1.5	1.5	1.4	1.4
Participation rate males (aged 20-64)		77.1	78.9	80.6	80.2	80.5
Participation rates females (aged 20-64)		63.9	67.8	70.7	70.9	71.8
Total participation rates (aged 20-64)		70.5	73.3	75.6	75.6	76.2
Unemployment rate		3.9	3.4	3.4	3.4	3.4
Population aged 65+ over total population		23.6	26.3	30.3	40.8	53.2

Table 8. Basic assumptions

	2004	2005	2006	2007	2008
Short-term interest rate[34] (annual average)		2.1	1.8	2.0	2.2
Long-term interest rate (annual average)		3.4	3.6	3.8	4.0
USD/€exchange rate (annual average) (euro area and ERM II countries)		1.25	1.21	1.22	1.22
Nominal effective exchange rate		-0.6	-0.3	0.7	0.0
(for countries not in euro area or ERM II) exchange rate vis-à-vis the €(annual average)		n. a.	n. a.	n. a.	n. a.
World excluding EU, GDP growth*					
EU GDP growth		1.5	1.6	2.4	2.4
Growth of relevant foreign markets		4.5	4.8	6.0	6.0
World import volumes, excluding EU*					
Oil prices, (Brent, USD/barrel)		58.0	62.0	60.0	60.0

*Among the external assumption provided additionally by the Austrian authorities there are no specific assumptions concerning world excluding EU, GDP growth. There are assumptions though about OECD countries in 2005 and 2006 and the world economy in 2007 and 2008.

**In the above-mentioned external assumptions there are only projections for volumes of world trade but not specifically for import volumes.

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[34]   If necessary, purely technical assumptions.

Annex 2: Compliance with the code of conduct

The table below provides a detailed assessment of whether the programme respects the requirements of Section II of the new code of conduct. It is in four parts, covering compliance with (i) the window for the date of submission of the programme; (ii) the model structure (table of contents) in Annex 1 of the code; (iii) the data requirements (model tables) in Annex 2 of the code; and (iv) other information requirements. In the main text, points (ii) and (iii) are grouped into the "format" requirements of the code, whereas point (iv) refers to its "content" requirements.

Guidelines in the new code of conduct	Yes	No	Comments
1. Submission of the programme			
Programme was submitted not earlier than mid-October and not later than 1 December[1].	X		
2. Model structure			
The model structure for the programmes in Annex 1 of the code of conduct has been followed.	X		
3. Model tables (so-called data requirements)			
The quantitative information is presented following the standardised set of tables (Annex 2 of the code of conduct).	X		
The programme provides all compulsory information in these tables.	X		
The programme provides all optional information in these tables.		X	
The concepts used are in line with the European system of accounts (ESA).	X		
4. Other information requirements			
a. Involvement of parliament			
The programme mentions its status vis-à-vis the national parliament.		X	
The programme indicates whether the Council opinion on the previous programme has been presented to the national parliament.		X	
b. Economic outlook			
Euro area and ERM II Member States uses the "common external assumptions" on the main extra-EU variables.		X	Assumptions partly from national source
Significant divergences between the national and the Commission services' economic forecasts are explained[12].			Not applicable
The possible upside and downside risks to the economic outlook are brought out.		X	
The outlook for sectoral balances and, especially for countries with a high external deficit, the external balance is analysed.	X		Only summary data provided
c. Monetary/exchange rate policy			
The convergence programme presents the medium-term monetary policy objectives and their relationship to price and exchange rate stability.			Not applicable
d. Budgetary strategy			
The programme presents budgetary targets for the general government balance in relation to the MTO, and the projected path for the debt ratio.	X		

Guidelines in the new code of conduct	Yes	No	Comments
In case a new government has taken office, the programme shows continuity with respect to the budgetary targets endorsed by the Council.			Not applicable
When applicable, the programme explains the reasons for possible deviations from previous targets and, in case of substantial deviations, whether measures are taken to rectify the situation, and provide information on them.			Not applicable
The budgetary targets are backed by an indication of the broad measures necessary to achieve them and an assessment of their quantitative effects on the general government balance is analysed.	X		But not sufficiently
Information is provided on one-off and other temporary measures.			Not applicable
The state of implementation of the measures (enacted versus planned) presented in the programme is specified.			Not applicable
If for a country that uses the transition period for the classification of second-pillar funded pension schemes, the programme presents information on the impact on the public finances.			Not applicable
e. "Major structural reforms"			
If the MTO is not yet reached or a temporary deviation is planned from the achieved MTO, the programme includes comprehensive information on the economic and budgetary effects of possible 'major structural reforms' over time.			Not applicable
The programme includes a quantitative cost-benefit analysis of the short-term costs and long-term benefits of such reforms.			Not applicable
f. Sensitivity analysis			
The programme includes comprehensive sensitivity analyses and/or develops alternative scenarios showing the effect on the budgetary and debt position of: a) changes in the main economic assumptions b) different interest rate assumptions c) for non-participating Member States, different exchange rate assumptions d) if the common external assumptions are not used, changes in assumptions for the main extra-EU variables.	X		
In case of such "major structural reforms", the programme provides an analysis of how changes in the assumptions would affect the effects on the budget and potential growth.			Not applicable
g. Broad economic policy guidelines			
The programme provides information on the consistency with the broad economic policy guidelines of the budgetary objectives and the measures to achieve them.	X		Only implicit reference
h. Quality of public finances			
The programme describes measures aimed at improving the quality of public finances on both the revenue and expenditure side (e.g. tax reform, value-for-money initiatives, measures to improve tax collection efficiency and expenditure control).	X		
i. Long-term sustainability			
The programme outlines the country's strategies to ensure the sustainability of public finances, especially in light of the economic and budgetary impact of ageing populations.	X		
Common budgetary projections by the AWG are included in the programme. The programme includes all the necessary additional information. (…) To this end, information included		X	

Guidelines in the new code of conduct	Yes	No	Comments
in programmes should focus on new relevant information that is not fully reflected in the latest common EPC projections.			
j. Other information (optional)			
The programme includes information on the implementation of existing national budgetary rules (expenditure rules, etc.), as well as on other institutional features of the public finances, in particular budgetary procedures and public finance statistical governance.		X	

Notes:
[1]The code of conduct allows for the following exceptions: (i) Ireland should be regarded as complying with the deadline in case of submission on "budget day", i.e. traditionally the first Wednesday of December, (ii) the UK should submit as close as possible to its autumn pre-budget report; and (iii) Austria and Portugal cannot comply with the deadline but will submit no later than 15 December.
[2]To the extent possible, bearing in mind the typically short time period between the publication of the Commission services' autumn forecast and the submission of the programme.

Annex 3: Consistency with the broad economic policy guidelines

The table below provides an overview of whether the strategy and policy measures in the programme are consistent with the broad economic policy guidelines in the area of public finances included in the integrated guidelines for the period 2005-2008.

Integrated guidelines	Yes	No	Not applicable
1. To secure economic stability			
− Member States should respect their medium-term budgetary objectives. As long as this objective has not yet been achieved, they should take all the necessary corrective measures to achieve it[1].	X (but measures should be further specified)		
− Member States should avoid pro-cyclical fiscal policies[2].			X
− Member States in excessive deficit should take effective action in order to ensure a prompt correction of excessive deficits[3].			X
− Member States posting current account deficits that risk being unsustainable should work towards (…), where appropriate, contributing to their correction via fiscal policies.			X
2. To safeguard economic and fiscal sustainability In view of the projected costs of ageing populations,			
− Member States should undertake a satisfactory pace of government debt reduction to strengthen public finances.	X		
− Member States should reform and re-enforce pension, social insurance and health care systems to ensure that they are financially viable, socially adequate and accessible (…)	X		
3. To promote a growth- and employment-orientated and efficient allocation of resources			
Member States should, without prejudice to guidelines on economic stability and sustainability, re-direct the composition of public expenditure towards growth-enhancing categories in line with the Lisbon strategy, adapt tax structures to strengthen growth potential, ensure that mechanisms are in place to assess the relationship between public spending and the achievement of policy objectives and ensure the overall coherence of reform packages.	X		
Notes: [1]As further specified in the Stability and Growth Pact and the new code of conduct, i.e. with an annual 0.5% of GDP minimum adjustment in structural terms for euro area and ERM II Member States. [2]As further specified in the Stability and Growth Pact and the new code of conduct, i.e. Member States that have already achieved the medium-term objective should avoid pro-cyclical fiscal policies in "good times". [3]As further specified in the country-specific Council recommendations and decisions under the excessive deficit procedure.			

Annex 4: Assessment of tax projections

Table 6 compares the tax projections of the programme with those of the Commission services' autumn 2005 forecast and Table 7 those of the Commission services' autumn forecast with tax projections obtained by using standard ex-ante elasticities, as estimated by the OECD. The tables summarise the results for the total tax-to-GDP ratio. The underlying analysis is carried out exploiting information for the four major tax categories, i.e. indirect taxes, corporate and private income taxes and social contributions (see tables below)[35]. Conceptually, the analysis draws on the definition of a semi-elasticity, which measures the change in a ratio vis-à-vis the relative change in the denominator. The semi-elasticity of the tax-to-GDP ratio of the *i-th* tax $\frac{T_i}{Y}$ can be written as:

$$\eta_i = \frac{d\left(\frac{T_i}{Y}\right)}{dY} Y = \left(\frac{dT_i}{dY}\frac{Y}{T_i} - 1\right)\frac{T_i}{Y} = \left(\frac{dT_i}{dB_i}\frac{B_i}{T_i}\frac{dB_i}{dY}\frac{Y}{B_i} - 1\right)\frac{T_i}{Y} = (\varepsilon_{T_i,B_i}\varepsilon_{B_i,Y} - 1)\frac{T_i}{Y}$$

where ε_{T_i,B_i} and $\varepsilon_{B_i,Y}$ denote the elasticity of the *i-th* tax T_i relative to its tax base B_i and the elasticity of the tax base B_i relative to aggregate GDP Y respectively.

To the extent that ε_{T_i,B_i} is derived from observed or projected data, it will typically reflect (i) the effect of discretionary measures (including one-offs) and (ii) the tax elasticity[36]. By contrast, if ε_{T_i,B_i} is the standard *ex-ante* elasticity, as estimated by the OECD, it will be net of discretionary measures.

The second elasticity $\varepsilon_{B_i,Y}$ can be used as an indicator of the tax intensity of GDP growth; for instance, a higher elasticity of consumption relative to GDP means that for the same GDP growth indirect taxes will be higher.

The definition of a semi-elasticity has two practical implications. First, any change in the tax-to-GDP ratio of the *i-th* tax can be written as the product of the semi-elasticity and GDP growth:

$$d\left(\frac{T_i}{Y}\right) = \eta_i \cdot \frac{dY}{Y}$$

and the change in the total tax-to-GDP ratio is the sum:

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[35] Private and corporate income taxes are generally not provided, neither in the programme nor in the Commission services' autumn 2005 forecast. Only the aggregate, direct income taxes, is given. For the purpose of this exercise the breakdown is obtained using the average shares over the past ten years, i.e. the composition of direct taxes is assumed to stay constant.

[36] The observed or projected elasticity (ex-post elasticity) of the *i*-th tax also includes the effect of other factors (OF) such as discretionary measures: $\frac{\Delta T_i}{T_i} = \varepsilon_{T_i,B_i\,exante}\frac{dB_i}{B_i} + \frac{OF_i}{T_i} = \varepsilon_{T_i,B_i\,ex\,post}\frac{dB_i}{B_i}.$

$$\sum_i d\left(\frac{T_i}{Y}\right) = \sum_I \eta_i \frac{dY}{Y}.$$

Second, differences between two tax projections can be decomposed into an elasticity component and a composition component:

$$d\left(\frac{T_i}{Y}\right)' - d\left(\frac{T_i}{Y}\right) = \left[\left(\varepsilon'_{T_i,B_i}\varepsilon'_{B_i,Y} - 1\right)\frac{T_i}{Y} - \left(\varepsilon_{T_i,B_i}\varepsilon_{B_i,Y} - 1\right)\frac{T_i}{Y}\right]\frac{dY}{Y}.$$

If $(\varepsilon'_{T_i,B_i} - \varepsilon_{T_i,B_i}) = \alpha_i;$ $(\varepsilon'_{B_i,Y} - \varepsilon_{B_i,Y}) = \beta_i,$

then $d\left(\frac{T_i}{Y}\right)' - d\left(\frac{T_i}{Y}\right) = \left[\left(\alpha_i\varepsilon_{B_i,Y} + \beta_i\varepsilon_{T_i,B_i} + \alpha_i\beta_i\right)\frac{T_i}{Y}\right]\frac{dY}{Y}$

where $\alpha_i\varepsilon_{B_i,Y}\frac{T_i}{Y}\frac{dY}{Y}$ determines the elasticity component and $\beta_i\varepsilon_{T_i,B_i}\frac{T_i}{Y}\frac{dY}{Y}$ the composition component. The third component in the equation $\alpha_i\beta_i\frac{T_i}{Y}\frac{dY}{Y}$ measures the interaction of the elasticity and the composition components. It is generally small but can become important in some cases. The tax elasticity relative to GDP of total taxes is obtained as $\varepsilon = \sum_i w_i\varepsilon_{T_iB_i}\varepsilon_{B_iY}$ with w_i the share of the *i-th* tax in the overall tax burden.

The tables below report the results of the assessment of the tax projections presented in the programme by major tax category, which, as mentioned above, are the basis for the aggregated results reported in Tables 6 and 7.

Assessment of tax projections by major tax category

	2006		2007		2008	p.m.:
	COM	SP	COM[2]	SP	SP	OECD[1]
Taxes on production and imports: Change in tax-to-GDP ratio	0.1	-0.2	0.1	-0.2	-0.1	/
Difference	-0.3		-0.3		/	/
of which[3]*: - elasticity component*	-0.3		-0.3		/	/
- composition component	0.0		0.0		/	/
p.m. Observed elasticity to tax base[4]	1.1	0.5	1.1	0.6	0.9	1.0
Social contributions: Change in tax-to-GDP ratio	0.1	-0.1	-0.1	-0.1	-0.1	/
Difference	-0.2		0.0		/	/
of which[3]*: - elasticity component*	-0.2		-0.1		/	/
- composition component	0.0		0.1		/	/
p.m. Observed elasticity to tax base[5]	1.1	0.8	1.1	0.9	0.9	1.0
Personal income tax[6]: Change in tax-to-GDP ratio	-0.4	-0.4	0.2	-0.5	-0.1	/
Difference	0.0		-0.7		/	/
of which[3]*: - elasticity component*	0.1		-0.7		/	/
- composition component	0.0		0.1		/	/
p.m. Observed elasticity to tax base[5]	-0.3	-0.1	2.0	-0.3	0.9	2.2
Corporate income tax[6]: Change in tax-to-GDP ratio	-0.1	-0.1	0.0	-0.1	0.0	/
Difference	0.0		-0.2			/
of which[3]*: - elasticity component*	0.0		-0.2		/	/
- composition component	0.0		0.0		/	/
p.m. Observed elasticity to tax base[7]	-0.3	-0.1	1.4	-0.3	0.7	1.0

Notes:

[1] OECD ex-ante elasticities

[2] On a no-policy change basis

[3] The decomposition is explained in Annex 4

[4] Elasticity relative to private consumption expenditure

[5] Elasticity relative to compensation of employees

[6] Taxes on income and wealth are split into private and corporate income tax using the average tax share over the past ten years, i.e. the share is assumed to be constant over the programme period

[7] Elasticity relative to gross operating surplus

Source:

Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)

Assessment of tax elasticities by major tax category

	2006		2007	
	COM (observed)	**ex-ante[1]**	**COM[2] (observed)**	**ex-ante[1]**
Taxes on production and imports:				
Change in tax-to-GDP ratio	0.1	0.0	0.1	0.0
Difference	-0.1		-0.1	
of which[3]: - elasticity component	0.0		0.0	
- composition component	-0.1		0.0	
p.m.: Observed elasticity: - of taxes to tax base[4]	1.1	1.0	1.1	1.0
- of tax base[4] to GDP	1.1	1.0	1.1	1.0
Social contributions:				
Change in tax-to-GDP ratio	0.1	-0.2	-0.1	-0.3
Difference	-0.3		-0.2	
of which[3]: - elasticity component	-0.1		0.0	
- composition component	-0.2		-0.1	
p.m.: Observed elasticity: - of taxes to tax base[5]	1.1	1.0	1..1	1.0
- of tax base[5] to GDP	1.0	0.6	0.8	0.6
Personal income tax[6]:				
Change in tax-to-GDP ratio	-0.4	0.1	0.2	0.1
Difference	0.6		-0.1	
of which[3]: - elasticity component	0.9		0.0	
- composition component	0.0		-0.1	
p.m.: Observed elasticity: - of taxes to tax base[5]	-0.3	2.2	2.0	2.2
- of tax base[5] to GDP	1.0	0.6	0.8	0.6
Corporate income tax[6]:				
Change in tax-to-GDP ratio	-0.1	0.1	0.0	0.1
Difference	0.2		0.0	
of which[3]: - elasticity component	0.1		0.0	
- composition component	0.0		0.1	
p.m.: Observed elasticity: - of taxes to tax base[7]	-0.3	1.0	1.4	1.0
- of tax base[7] to GDP	1.0	1.7	1.2	1.7

Notes:

[1]Tax projections obtained by applying ex-ante standard tax elasticities estimated by the OECD

[2]On a no-policy change basis

[3]The decomposition is explained in the text above

[4]Tax base = private consumption expenditure

[5]Tax base = compensation of employees

[6]Taxes on income and wealth are split into private and corporate income tax using the average tax share over the past ten years, i.e. the share is assumed to be constant over the programme period

[7]Tax base = gross operating surplus

Source:

Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)

Annex 5: The rolling debt reduction benchmark

The rolling debt reduction benchmark discussed in Box 2 is calculated for successive five-year periods through a recursive application of the formula:

$$\left(\frac{D_t}{Y_t}\right)_{benchmark} = 0.05 * \left[60 - \left(\frac{D_{t-1}}{Y_{t-1}}\right)_{benchmark}\right] + \left(\frac{D_{t-1}}{Y_{t-1}}\right)_{benchmark}$$

where t is a time subscript and D and Y are the stock of government debt and nominal GDP, respectively (note that, in the first year of the five-year period, the debt ratio in the previous year is the actual debt ratio).

The change in the debt ratio can be decomposed as follows (assuming that the stock-flow adjustment is equal to zero):

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{DEF_t}{Y_t} - \left(\frac{y_t}{1+y_t}\right) * \left(\frac{D_{t-1}}{Y_{t-1}}\right) \cong \frac{DEF_t}{Y_t} - y_t * \left(\frac{D_{t-1}}{Y_{t-1}}\right)$$

where DEF is the government deficit and y represents nominal GDP growth.

Noting that 0.05*60 = 3, the formula for the rolling debt reduction benchmark describes the path for convergence of the debt ratio towards 60% of GDP, which would take place with the deficit at 3% of GDP and nominal GDP growth at 5%. For nominal GDP growth rates higher than 5%, the benchmark can be respected with deficits in excess of 3% of GDP; for nominal GDP growth rates lower than 5%, respect of the benchmark necessitates deficits lower than 3% of GDP.

Annex 6: Indicators of long-term sustainability

Table A1: Underlying assumptions compared

% of GDP	2010		2020		2030		2050	
	EPC	SCP	EPC	SCP	EPC	SCP	EPC	SCP
Labour productivity growth	1.7	1.8	1.8	1.8	1.7	1.7	1.7	1.7
Real GDP growth	2.6	1.5	1.7	1.5	1.0	1.4	1.2	1.4
Participation rate males (aged 15-64)	82.2	78.9	83.3	80.6	83.2	80.2	83.8	80.5
Participation rates females (aged 15-64)	70.1	67.9	72.9	70.7	73.5	70.9	74.2	71.8
Total participation rates (aged 15-64)	76.1	73.3	78.1	75.6	78.3	75.6	79.1	76.2
Unemployment rate	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4
Population aged 65+ over total population	17.7	26.3	20.0	30.3	25.0	40.8	30.1	53.2

Note: SCP data for population aged 65+ expressed as persons aged 65 or more over the population aged 15-64.

Table A2: Long-term projections

Main assumptions - programme scenario (as % GDP)	2008	2010	2020	2030	2040	2050	changes	Impact on S2
Total age-related spending	25.5	25.0	26.0	27.6	27.1	26.4	0.9	0.9
Pensions	13.5	13.0	13.7	15.0	14.1	13.1	-0.4	0.0
Health care	5.2	5.3	5.6	6.0	6.3	6.4	1.2	0.9
Care of the elderly	0.8	0.8	1.0	1.1	1.3	1.5	0.7	0.5
Education	5.6	5.5	5.3	5.1	5.1	5.0	-0.6	-0.5
Unemployment benefits	0.4	0.4	0.4	0.4	0.4	0.4	0.0	0.0
Total primary non age-related spending	18.5	18.5	18.5	18.5	18.5	18.5	0.0	0.0
Total revenues	46.9	46.9	46.9	46.9	46.9	46.9	0.0	0.0

Table A3: The cost of a five-year delay in adjusting the budgetary position according to the S1 and S2

	S1	S2
2005 scenario	**0.1**	**0.0**
Programme scenario	**-0.2**	**-0.1**

Note: the cost of a delay shows the increase of the S1 and S2 indicators if they were calculated five years later.

Table A4: Debt development

Results (as % GDP)	2008	2010	2020	2030	2040	2050	changes
Programme scenario							
Gross debt	59.5	53.9	29.3	16.7	7.2	-9.2	-68.7
Gross debt, i + 1*	59.5	54.4	34.5	25.6	20.0	7.3	-52.2
Gross debt, i - 1*	59.5	53.3	24.7	9.7	-1.5	-18.5	-78.0
Adjusted gross debt	59.5	53.9	29.3	16.7	7.2	-9.2	-68.7
2005 Scenario							
Gross debt	60.5	57.9	49.5	55.9	68.8	78.5	18.0
Gross debt, i + 1*	60.5	59.0	56.5	70.2	93.8	118.4	58.0
Gross debt, i - 1*	60.5	56.7	43.2	44.3	50.4	51.8	-8.7
Adjusted gross debt	60.5	57.9	49.5	55.9	68.8	78.5	18.0

* *i + 1* and *i + 1* represents the evolution of debt under the assumption of the nominal interest rate being 100 basis points higher or lower throughout the projection period.