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Highlights in this issue:

- Incentives to work enhanced for most income groups
- Lower company taxes should reap medium-term benefits
- Risk of return to stop-and-go tax policy
- Tough choised required on the spending side

Tax cuts in Austria – Placebo or genuine reform?

*By Madeleine Mahovsky**

Summary

Stop-and-go policies have characterised the fiscal course in Austria for decades. While in all other EU-15 Member States the tax wedge on labour declined in the recent past, it continued to increase in Austria. The Austrian government, alarmed by the continuous increase the tax burden, announced to steer a different course: The new objectives are to reduce the tax burden significantly to below 40% of GDP and at the same time return to budgetary balance.

The tax break in personal income taxes targets above all low income earners, while providing considerable relief for 90% of the taxpayers. Triggered by similar measures in neighbouring countries, corporate taxes are lowered noticeably.

Despite considerable budgetary cost, boosting the deficit in 2005 by some 0.8 percentage points of GDP, the short-term impact on growth is estimated to remain quite limited. A crucial factor is the behaviour of private households, which in turn depends on the credibility of the new fiscal policy course. Based on experience, economic agents may believe that the tax break will be followed by tax hikes later on. Therefore, increasing precautionary savings would be a rational reaction. This would reduce the impact of the tax reform. To prevent this, tough measures curbing primary spending are called for.

The Austrian income tax reform 2004 and 2005

On 9 January 2004, the government agreed on the main features of the second step of a tax reform. Comments of the draft bill were collected until mid-March and the law is scheduled to pass parliament in June.

A considerable reduction in personal income and profit taxes takes effect in two steps. A first and minor phase started at the beginning of 2004 and the second phase is scheduled for 2005. In total, the net tax relief 2004/2005 will amount to € 3 billion or 1.3% of GDP. Family-related measures will become effective retroactively as of 1 January 2004, amounting to € 0.25 or 0.1% of GDP (on top of the first step worth 0.3% of GDP). Thus, the budgetary volume in 2005 will amount to € 2.25 billion or some 0.9% of GDP.

The main features of the tax package are the following:

- Reduction of the **corporate tax rate** from 34 to 25 per cent as of 2005. Thus, the new corporate tax rate will be the second lowest in EU-15, after

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EU enlargement
triggers drop in
corporate tax
rates

Ireland with 12.5%. Taking into account enlargement, the new rate will be equivalent to those in the Czech Republic and Slovenia, while corporate taxes in Slovakia, Poland (both 19%) and Hungary (16%) are clearly lower. This measure is estimated to burden the budget by € 1.15 billion or 0.5% of GDP in 2005.

Moreover, the package is geared towards facilitating taxation of company groups, including cross-border groups. Profits and losses can be allocated in flexible way, provided a certain share of the firm's turnover occurs in Austria. Finally, preferential treatment of retained earnings is targeted at SMEs, which should induce them to invest.

- **Income and wage taxes:** As of 2004, personal income tax cuts amounting to more than 0.1% of GDP became effective. However, being largely offset by a rise in social contributions, the impact on the general government budget should be neutral.

As of 2005, the number of tax brackets will be reduced from four to three. In the new system, the lowest tax rate will be increased, the two middle tax rates merged and the 50% rate remains unchanged. As a result, bracket creep will be more pronounced. Tax deductions will be extended and a zero-tax rate granted for yearly incomes up to € 15 770. Significant distortions caused by previous tax deductions, which had accumulated over the years, will be reduced.

Annual gross income in €	Tax rate in %
Up to 10 000	0.0
For 25 000	23.0
For 51 000	33.5
Beyond 51 000	50.0

Source: Austrian Ministry of Finance

In terms of budgetary cost, this element equals corporate taxation, resulting in expected revenue shortfalls of € 1.1 billion or 0.5% of GDP in 2005.

- **Family-related tax measures:** New tax deductions for families with children are being introduced, with amounts increasing for each child. However, this will concern only families with a single income earner. No changes are planned for families with two income earners. The budgetary cost is estimated at € 230 million or 0.1% of GDP.
- **Indirect taxes:** As of 2004, taxes on oil and energy have been increased. The 13th VAT prepayment, relevant only in cash terms but neutral in EDP definition, was abolished. As of 2005, excise duties with negligible revenue impact ("*Bagatellsteuern*") will be abolished.

Do taxes matter for macro-economic performance?

Although the level and the development of a country's tax burden is useful for identifying underlying fiscal trends, a high tax ratio cannot automatically be associated with poor growth performance and high unemployment. Tax burdens are determined by complex factors, as illustrated by steady growth in OECD tax-to-GDP ratios despite widespread cuts in tax rates. In periods of rapid growth, company profits increase and individual incomes are lifted into higher tax brackets. This is evidenced by an increase in the OECD average ratio of taxes in incomes and profits as percentage to GDP from 1995 to 2000. By contrast, an economic slowdown reduces this effect. Moreover, countries differ with regard to the extent to which they tax government-provided social benefits, and so increase their tax ratios without adding to the tax burden of economic activities.

As regards enterprise taxes, the economic literature stresses that corporate taxation is key in determining the attractiveness of a business location and has a direct impact on investment behaviour. A convenient vehicle to gauge these effects is the concept of the user cost of capital, or its shadow price. For Austria, Kaniovski (2002) shows that the impact of tax rate changes on investment varies greatly, depending

Corporate taxes
directly affect
investment
behaviour

Empirical results on the effects of labour taxation differ widely

on the fiscal instrument. He estimates similar elasticities of about one-third for both investment tax allowances and, with a reverse sign, for business tax rates. By contrast, negative investment elasticity is much lower for corporation taxes (only 0.1 pp. because interest on debt is tax deductible). The by far most powerful stimulus provides the rate of depreciation: a one percentage point increase in the depreciation rates boosts investment by 2.5 percentage points.

Does labour taxation matter for macro-economic performance? The tax wedge on labour is often identified as a key cause for high and persistent unemployment in Europe. However, results of recent empirical research differ substantially. In an influential paper, Daveri and Tabellini (2000) argue that the increase in unemployment and the slowdown in economic growth in Europe stem from higher labour taxes. An exogenous and lasting increase in labour costs reduces labour demand. Due to a substitution of capital for labour, the marginal product of capital falls, diminishing the incentive to invest and thus grow.

The findings of Daveri and Tabellini (2000) are often cited in support of a coordinated change in the tax system in the European Union and used as arguments calling for a reduction in non-wage labour costs. Their results, however, are not uncontroversial. For instance, based on a panel model for 18 OECD countries over the period 1966-90 Mendoza et al. (1997) conclude that tax ratios do not affect economic growth. This difference in results is quite remarkable and depends on the calculation of tax ratios as approximations for tax burdens.

From an employee's perspective, the effect of a change in income taxes is rather ambiguous

From an employee's perspective, the effect of a rise in income taxes is similar to the rise in the tax wedge on labour and is not as unambiguous as it may seem. A rise in taxation may induce workers to work less because the marginal rate of return on labour diminishes. Yet, it might as well induce them to work more in order to compensate for the loss in net income.

Conversely, employers react to changes in labour taxation in a straightforward manner, as labour demand is tightly linked to respective costs. The tax incidence of employers' contributions hinges on the firm's competitive position, which in most cases limits the scope for passing on such cost factors into prices.

Economic and budgetary effects of the Austrian reform

In 2005, the general government **deficit** is set to rise by 0.7 percentage points of GDP according to the official projections of the Finance Ministry or slightly more by 0.9 percentage points according to WIFO. In the Commission Spring 2004 Forecast, the general government deficit is projected to reach 1.9% of GDP, which is 0.4 percentage points above the target as laid out in the most recent update of the Austrian stability programme. This difference is related to factors increasing the deficit projection already in 2004 with knock-on effects into 2005.

Large relief for smaller incomes ...

Regarding **personal income taxes**, the individual tax relief varies greatly. It ranges from 0.2% to 6% or € 165 to 670 per year, with low-income earners benefiting most. The number of tax exempt persons, increases from 2.1 million to 2.55, representing almost half of the 5½ million taxpayers¹. On average, the tax reduction for the first three quartiles of taxpayers combined, accounting for 73% of personal income tax revenue, amounts to 2.6% (Bruckbauer 2004).

... but high income earners were almost completely forgotten

By sharp contrast, the highest income group with annual gross earnings above € 51 000, does hardly benefit from the reform. What is more, not even the nominal threshold was lifted, although it has remained unchanged for the last 15 years. Since 1989, the number of persons taxed at the maximum marginal rate more than doubled due to bracket creep reaching 180 000 in 2003.

The reduction in **company taxes** is targeted mainly towards incorporated enterprises. This has triggered sharp criticism by the political opposition, given that the vast majority of firms in Austria are small and medium-sized enterprises. However, incorporated enterprises, although representing only about one fifth of all firms, employ more than 60% of dependent labour and their investment accounts for more than 75% of the total. As regards the growth impact of the corporate tax cuts, the Federation of Austrian Industry is quite optimistic and tentatively estimates that industrial output will expand by an additional 1% in the next 3-5 years.

Positive impact on economic growth relatively limited

...

... considering the relatively high budgetary costs

The Austrian Institute of Economic Research (WIFO) evaluated the macroeconomic impact of the considerable tax relief, foreseeing an increase domestic demand. In particular, the rise in household disposable income should boost private consumption. The cuts in corporate tax rates increase the marginal product of capital, enhancing incentives to invest and thus to grow.

In a **model calculation**, WIFO (Aiginger et al. 2004) estimated that the positive impact of the tax reform 2004/2005 on GDP growth could amount to up to 0.4 percentage points in 2005 and up to 0.5 percentage points in 2006. The tax reform step 2005 accounts for 0.3 percentage points of the increase in 2005 and approximately 0.4 percentage points in 2006. Corporate tax cuts account for 0.1% of the additional growth effect in each year. Dependent employment is estimated to increase by 4000-5000 persons (0.1% of total employment in 2003).

In an internal calculation, the Austrian National Bank, finds much smaller overall effects. In 2004, additional GDP growth is estimated at a mere 0.03 percentage points and at 0.18 percentage points in 2005. This impact stems mainly from private consumptions, while the effect of the reduction in corporate taxes is clearly smaller.

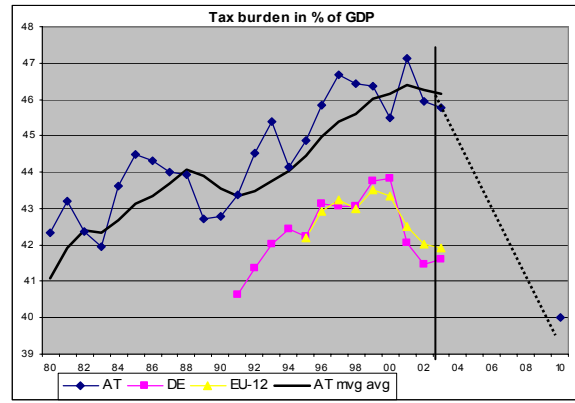
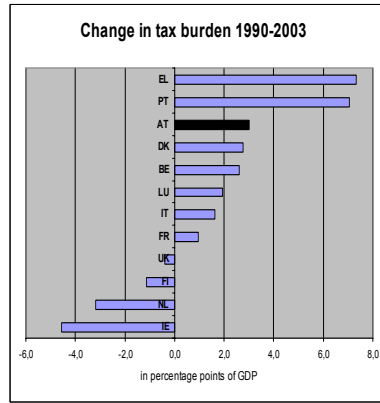
One crucial factor determining the additional growth effect is the **behaviour of private households**. During the long period of economic slowdown, households reduced their personal savings, thereby smoothing their consumption pattern. Therefore, it can be assumed that households will tend to restore savings ratios to previous levels. Clearly, this depends on the distributional effect of the tax break, as liquidity-constrained households would tend to spend the additional disposable income. The extent to which precautionary savings will prevail depends on two factors:

- First, confidence in the fiscal policy path. In this respect, the government needs to establish a new track record, which is not an easy task. After decades of experiencing expansionary measures being followed by tax hikes, individuals have formed firm expectations, which will prove difficult to alter. Yet, tax cuts must be perceived as permanent to maximise their effect.
- Second, the perceived relative position in the economic cycle might prove crucial. In the case of an (imminent) upswing households might be more willing to spend, partly induced by pent-up consumption demand. Such a situation would enhance the risk of a pro-cyclical effect, as pointed out in the Commission assessment of the last Stability Programme update. If, however, the economic slack were to continue, precautionary savings could absorb a large chunk of the increase in disposable income. Ironically, in such a context the potentially counter-cyclical effect of the tax relief would translate only by a fairly small margin into additional demand.

Tax burden - Trend reversal or overture for new hikes?

Steady growth in tax-to-GDP ratios has been common to most EU Member States for many years. In the recent past, however, several member states succeeded in reversing this trend, resulting in a decline in the EU average tax-to-GDP ratio to close to a level at the beginning of the nineties.

In Austria, by contrast, such a downward trend remains to be established, with the income tax break as an important step. The tax burden attained an all-time high in 2001, jumping by 1.5 percentage points in a single year to 47.2% of GDP, among the highest in the EU. This was the price paid for attaining a balanced budget for the first time in more than 25 years.



Bumpy course of fiscal policies: Any decline in the tax burden was quickly reversed in subsequent periods

The bumpy course of Austrian fiscal policy is well reflected in the uneven evolution of the tax burden. Traditionally, not only in the run-up to EMU, periods of fiscal expansion were followed by restrictive measures on the tax side. So-called “savings packages” did rarely consist in a genuine restructuring of expenditure, but rather, more often than not, circumscribed revenue-side consolidation. As a consequence, any drop in the tax-to-GDP ratio was more than reversed, if not in the following year, then shortly thereafter². A striking recent episode of the stop-and-go fiscal policy course was an income tax relief, effective as of 2000, which translated into a sizeable drop in the revenue ratio by 1 percentage point. In 2001, the budgetary ambitions of the, at the time new, government coalition were for early consolidation, which led to an impressive reduction of the general government deficit by some 1.7 percentage points of GDP. Little surprise, almost two thirds of the overall improvement stemmed from a rise in the revenue ratio, cancelling the previous year’s alleviating effect.

Since 1996, the tax wedge on labour rose only in Austria while it declined in all other 15 EU-Member States

A more specific, highly characteristic indicator is the tax wedge on labour income. According to the most recent edition of the OECD’s annual publication “*Taxing Wages*” (2004), the tax wedge for a typical production worker with two children, measured as a percentage of the overall cost to the employer, has declined in the last seven years by about 1½ percentage points across the OECD’s 30 member states. This, however, is not the case for Austria. From 1996 to 2003, the tax wedge in Austria has increased by 0.6 percentage points, while it has fallen in all other EU member states, with the exception of the two enlargement countries Poland and Slovakia.

Government target: Tax-to-GDP-ratio below 40% by 2010 and return to budgetary balance

The Austrian government, recognising the potentially detrimental effects of a high tax burden to economic growth, has set an ambitious policy target: By 2010, the tax-to-GDP-ratio should fall to below 40%, while returning to budgetary balance. How difficult is this task?

Primary spending adjustment need		
Target: tax-to-GDP-ratio < 40% by 2010 and return to budgetary balance		
% points of GDP	as of 2003	as of 2005
Total	6,5	5,8
Annually	0,8	0,7

Source: ECFIN calculations

Primary spending adjustment: tough arithmetics

The challenge consists in the need to cut primary expenditure. To achieve the two-fold target substantial reductions in primary spending are required (see table): In the seven years as of 2004, government primary spending would need to be cut by some 6.5 percentage points of GDP or between € 18 and 19 billion³. Per annum, this corresponds to 0.8% of GDP on average. Even when taking account of the substantial tax relief 2004/2005, the size of the total effort lessens only by 0.7 percentage points, leaving the adjustment need at almost 6 percentage points or some € 18 billion. Thus, per year primary expenditure would need to be cut by more than € 2 billion in the second half of the decade, in order to achieve the target.

The government thus faces an important challenge: reducing primary spending considerably in order to make the tax cuts credible.



Appraisal and conclusion

In several economic policy documents, among them the Broad Economic Policy Guidelines, the European Commission (2001, 2003b) formulated key criteria for developing tax policy in the EU.

- Tax cuts should be focused on areas where they have beneficial supply side effects in order to increase growth potential and employment. The need to reduce the fiscal pressure on labour and non-wage labour cost is emphasised, in particular on relatively unskilled and low-paid labour.
- Moreover, it is essential to strike a balance between cutting taxes, investing in public services and sustaining fiscal consolidation so as to achieve a durable reduction in the overall tax burden.
- Finally, tax systems should be transparent in order to ensure that the right tax is paid at the right time, and that opportunities for fraud and evasion are minimised.

How does the Austrian income tax reform fare with respect to those criteria? Overall, relatively well, despite some less positive aspects.

*Corporate tax cuts
promising...*

In terms of competitiveness and attractiveness as a business location, the tax package can be considered promising. Although other tax instruments are more effective in triggering additional investment than changes in corporate taxes, the positive long-term effects appear to outweigh potential short-term gains. In particular in the light of recent tax cuts in Slovakia, it is central to prevent re-location of firms, which are currently situated in Austria. Moreover, targeting incorporated enterprises implies a considerable leverage effect.

*...but adverse
incentives for
female labour
participation*

The incentive to work is enhanced for most income groups, with two notable exceptions: High-income earners benefit least and low-income earners, who are tax exempt, are burdened by the increase in social security contributions. Moreover, with respect to female labour market participation, the tax package clearly gives the wrong incentives. New tax deductions for children concern only families with a single income earner – an aspect which is strongly criticised in the internal debate.

*Genuine reform
remains wanting*

In terms of making the tax system simpler and more transparent, the package fares poorly. While some distortions in personal income tax rates will be reduced as of 2005, new tax deductions will be introduced. Moreover, previous tax measures in 2000 and thereafter broadened the tax base, while exemptions and allowances introduced in 2004 undermine this achievement. Therefore, an opportunity was missed to enhance the tax system's transparency and diminish its complexity.

*Cuts in direct taxes
lower the tax*

With regard to bringing down the overall tax burden, the short-term outlook suggests a sharp decline in the revenue ratio. However, the medium term outlook is rather uncertain for several reasons: First, the deficit is projected to widen by a larger margin than expected in the updated stability programmes. While planned to be of a temporary nature, the deficit increase might prove persistent. This would call for an additional adjustment effort. Second, this need could be enhanced due to lower-than-expected savings from structural measures. Third, Austria's fiscal policy has a long tradition of reversing tax cuts. Thus, confidence in permanently higher future income via tax reductions needs to be built up, which takes time. In sum, this raises some doubts on both the durability of the tax reduction and the return to budgetary balance.

*...but sizeable cuts
in primary
expenditure needed*

In sum, if Austria is to return to budgetary balance and if government wants to meet its objective of reducing the tax burden to below 40% of GDP by 2010, then a thorough review of public spending becomes all the more pressing in the years to come. Cutting public expenditure will thus prove central to making the tax reductions credible.



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- ¹ Taxpayers comprise wage earners and retired persons but exclude those who were exempt from taxes in 2003
- ² From 1976 to 2002 significant drops in the revenue ratio by more than 0.9 percentage points compared with the previous year occurred only four times: in 1982 by -1.0 pp, in 1989 by -1.2 pp, in 1994 -1.0 pp, and in 2000 by -1.0 pp. They were more than reversed by 1984, 1992, 1996 and 2001.
- ³ The adjustment need was computed as follows: $d=g_c+g_k+ib-t$, where d is the general government deficit, g_c government primary expenditure, g_k government gross fixed capital formation, ib the interest burden on debt, t taxes and social security contributions. Assumptions for 2010: revenue ratio 40% of GDP, deficit = 0% of GDP. Debt developments as in Commission Spring forecast until 2005, until 2007 extrapolated on basis of deficit ratios as given in updated stability programme of Nov. 2003, deficits until 2010 assumed to decrease at a similar pace, stock-flow adjustment = 0. Interest rate on government debt 4.8% as (implicitly) reported in spring 2004 notification, constant as of 2004.

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