COMMISSION OF THE EUROPEAN COMMUNITIES

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Recommendation for a

COUNCIL OPINION

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

On the Updated Stability Programme for Austria, 2003-2007

(presented by the Commission)

CONFIDENTIAL

EXPLANATORY MEMORANDUM

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

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

According to the Regulation, the updated stability programmes, to be presented annually, may also be examined by the Council in accordance with these same procedures. The first annual update, covering the period 2000-2003, was submitted on 28 March 2000 and assessed by the Council on 8 May 2000[3]. The second annual update, covering the period 2000-2004, was submitted on 19 December 2000 and assessed by the Council on 12 February 2001[4]. The third annual update, covering the period 2001-2005, was submitted on 27 November 2001 and assessed by the Council on 22 January 2002[5].

Austria submitted its fourth and most recent update of the stability programme, covering the period 2003-2007, on 25 March 2003. The Commission services have carried out a technical evaluation of this updated programme, which warrants the following assessment:

> The new Austrian government, which was sworn in on 28 February, following the early elections of 24 November 2002, presented the update within a relatively short period of time. However, the draft budget for 2003 that would have provided more detailed quantitative information, was not available at the time of the update's submission. Moreover, the caretaker government, in office at the time, decided not to present the updated programme within the required deadlines. The update therefore complies only partly with the requirements of the revised "code of conduct on the content and format of stability and converge programmes"[6].
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> Within the period covered by the updated stability programme, the government plans major reforms, affecting both budgetary revenues and expenditure. Although in substance the planned measures are described in some detail, more quantitative information would have been appreciated. While partly explained by the absence of a budget for 2003 and the speedy submission of the programme update after the

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1 OJ L209, 2.8.1997

2 OJ C42/5, 17.2.1999

3 OJ C162/1, 10.6.2000

4 OJ C77/6, 9.3.2001

5 OJ C33/5, 6.2.2002

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

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government had taken office, it would have been desirable to support the political reform objectives by concrete calculations and more detailed estimates of their effects. In particular, the long-term sustainability projections do not incorporate the budgetary effects of the planned pension reform, one of the programme's corner-stones, which is a major drawback of the update.

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

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

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

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

Figures for gross government debt were significantly revised upwards, in 2001 following a Eurostat decision on securitisation operations[7], and in 2002 due to a rectification of the Austrian debt reporting related to the inclusion of bonds issued in order to finance state-owned enterprises. As a result, general government debt ratcheted up by 6.6 percentage points to 67.8% of GDP in 2002. Consequently, the decline in the debt-to-GDP ratio is significantly delayed compared with the previous version of the programme. The update expects debt-to-GDP-ratio to decrease from its peak in 2002 to slightly below the 60% reference value in 2007, while the previous version of the programme foresaw that move for 2002.

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

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

The government deficit projections hinge crucially on the successful implementation of the planned savings measures. Any shortfalls in this respect would cause the estimated budgetary outcome to deviate further from balance, unless the tax reform were downsized to match expenditure overruns. Therefore, the main risk to the government's strategy relates to an asymmetric implementation of the expenditure and revenue side measures. If the planned savings were realised only partially and

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

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the tax relief fully implemented, the budgetary leeway would be insufficient to withstand a normal cyclical downturn without discretionary counter-action.

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

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

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

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

As regards the long-term sustainability of public finances, the Commission considers the assessment provided in the stability programme as complacent. On the basis of current policies, the risk of unsustainable public finances in terms of emerging budget imbalances cannot be excluded. This is attributable to the high initial level of public spending on pensions, amounting to some 15% of GDP, and its projected

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increase, to a level that would be well above that observed in most EU countries. A further element of risk is the planned reduction of primary surplus during the programme period.

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

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

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

Recommendation for a

COUNCIL OPINION

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

On the Updated Stability Programme for Austria, 2001-2005

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THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council regulation (EC) No. 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[8], and in particular Article 5(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

On [13 May 2003] the Council examined the updated stability programme for Austria which covers the period 2003-2007. The Council notes that the new Austrian government, which was sworn in on 28 February, following the early general elections of 24 November 2002, was able to present a programme update within a relatively short period of time. However, the draft budget for 2003 that would have allowed the Council to benefit from more detailed quantitative information, was not available at the time of the update's submission. Moreover, the caretaker government, in office at the time, decided not to present the updated programme within the required deadlines. The Council therefore considers that the update complies only partly with the requirements of the revised "code of conduct on the content and format of stability and converge programmes"[9].

The Council notes with satisfaction that, in spite of lower-than-projected growth, government finances in 2001 improved more rapidly than expected, although this favourable result was brought about mainly by a strong increase in tax revenues. However, in 2002 government finances weakened noticeably and slipped from the target, underlining the fragility of the earlier consolidation process.

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8 OJ L209/1, 2.8.1997

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

The Council notes, moreover, that the debt ratio, which is still above the 60% of GDP reference value, increased substantially in 2001/2002, mostly due to a rectification in the Austrian gross debt reporting. The Council notes that, as a consequence, the goal of bringing gross consolidated debt below the 60% of GDP reference value has now been delayed.

The update projects the general government deficit to widen from 0.6% of GDP in 2002 to 1.3% in 2003. After a temporary improvement in 2004, the deficit is projected to increase markedly to 1.5% in 2005 owing to a sizeable income tax reform. Thereafter, the deficit is estimated to gradually narrow to 1.1% of GDP in 2006 and 0.4% of GDP by 2007. The cyclically-adjusted deficit follows the pattern of the nominal figures: it widens by 0.5 percentage points in 2003 to some 1% of GDP, improves by virtually the same amount in 2004, before rising strongly to 1.3% in 2005 due to the planned net tax relief. Despite narrowing thereafter, the deficit in cyclically-adjusted terms remains at 1.1% of GDP in 2006 and improves by the required ½ percentage point to 0.5% of GDP only as late as in 2007. The government gross debt is expected to decrease from its peak of 67.8% of GDP in 2002 to slightly below the 60% reference value in 2007.

The budgetary projections of the programme are based on a macro-economic scenario expecting economic activity to gradually resume from its current cyclical weakness. Real GDP growth is forecast to accelerate from 1.0 % in 2002 to 2½% by 2005 and thereafter, amounting to annual average growth of 2.1% over the entire programme period. Although somewhat above trend, the Council considers this growth outlook feasible, given that no significant macroeconomic imbalances prevail in the Austrian economy and provided that the external environment improves as projected.

The Council notes that the Austrian government has abandoned its previous target of maintaining budgetary balance and moving to a small surplus in 2004 and 2005. The Council recalls that in its opinion[10] on the last update it considered a budgetary surplus in the medium term central in bringing down the debt level decisively, which the Council regarded as appropriate in view of the long-term expenditure pressures resulting from population ageing.

The Council welcomes that important structural savings measures are envisaged in the updated programme. In particular, the Council strongly encourages the Austrian government to pursue with determination the ambitious reform projects in the fields of pensions and health care, addressing many of the key problems in these areas. The Council emphasised repeatedly, also in its opinion on the last update and in the Broad Economic Policy Guidelines, the importance of raising the low effective retirement age in Austria and encouraging labour force participation, in particular of older workers and women. Therefore, the Council considers the planned pension and health care reforms, provided they are fully implemented, vital for containing upward pressure on expenditures in the long run, apart from important medium- and even short-term budgetary effects.

Likewise, the Council encourages the Austrian government to implement its plans for rationalising public administration, thereby enhancing the accomplishments to

[10] OJ C33/5, 6.2.2002

date. Beyond these undertakings, the national stability pact should be fully implemented, which would require spending restraint to attain sustainable structural surpluses at the Länder level.

The Council notes the Austrian government's intention to reduce, as recommended, the high tax burden significantly. In particular, the Council invites the Austrian government to implement the reduction in non-wage labour cost, already postponed several times. The Council recalls, however, its opinion on the last update, stating that revenue reductions should be accompanied by equivalent reductions of expenditure. Therefore, it is deemed appropriate to compensate the cost of the tax reform by additional structural expenditure cuts in order to avoid the projected sizeable increase in the cyclically-adjusted deficit. Past experience shows that tax cuts only partly matched by commensurate spending restraint are a particularly risky strategy.

Given the considerable widening of the deficit, both in nominal and structural terms after 2004, the Council considers that the envisaged path of government finances in the updated stability programme is only partly in line with the requirements of the Stability and Growth Pact. Although the projected path of government finances would leave sufficient safety margin to prevent the deficit from breaching the 3% of GDP reference value in the event of a normal cyclical downturn, the risks to the government's strategy are non-negligible. In particular, if the announced expenditure savings were only partly implemented, Austria would not have sufficient budgetary leeway to let the automatic stabilisers work fully in the event of a cyclical slowdown.

The Council, therefore, considers that the expenditure cuts need to be implemented as planned. In addition, the envisaged tax relief ought to be accompanied by additional expenditure restraint in order to avoid the risk of budgetary slippage and to allow Austria to return earlier than foreseen to a budgetary position close to balance. Already in 2003, the government should seek to achieve a better deficit outcome than projected, especially if growth should turn out higher than expected or if the flood-related emergency funds were not fully called upon.

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