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COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 13.02.2008
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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 of Austria, 2007-2010**

(presented by the Commission)

# EXPLANATORY MEMORANDUM

## 1. GENERAL BACKGROUND

The Stability and Growth Pact is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation. The 2005 reform of the Pact acknowledged its usefulness in anchoring fiscal discipline but sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run.

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1], which is part of the Stability and Growth Pact, stipulates that each Member State has to submit, to the Council and the Commission, a stability or convergence programme and annual updates thereof. Member States that have already adopted the single currency submit (updated) stability programmes and Member States that have not yet adopted it submit (updated) convergence programmes. The first stability programme of Austria was submitted in November 1998. In accordance with the Regulation, the Council delivered an opinion on it on 18 January 1999 on the basis of a recommendation from the Commission and after having consulted the Economic and Financial Committee. As regards updated stability and convergence programmes, the regulation foresees that these are assessed by the Commission and examined by the Committee and if necessary and following the same procedure as set out above, the updated programmes may be examined by the Council.

## 2. BACKGROUND FOR THE ASSESSMENT OF THE UPDATED PROGRAMME

The Commission has examined the most recent update of the stability programme of Austria, submitted on 21 November 2007, and is recommending a Council opinion on it (see box for the main points covered by the assessment).

In order to set the scene against which the budgetary strategy in the updated stability programme is assessed, the following paragraphs summarise:

(1) the most recent assessment of the country's position under the preventive arm of the Stability and Growth Pact (summary of the Council opinion on the previous update of the stability programme).

(2) the orientations for budgetary policies adopted by the April 2007 Eurogroup.

(3) the March 2007 update of the country-specific broad economic policy guidelines in the area of budgetary policies.

(4) the Commission's assessment of the October 2007 implementation report of the national reform programme.

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[1] OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). The documents referred to in this text are available at: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

## 2.1. The assessment in the Council opinion on the previous update

In its opinion of 10 July 2007, the Council summarised its assessment of the previous update of the stability programme, covering the period 2006-2010, as follows:

"Overall, the Council considers that, in a context of robust growth prospects, the programme envisages slow progress towards the MTO through a relatively back-loaded adjustment that is based mainly on not-fully-specified expenditure restraint. Despite Austria being in good times and not having reached its MTO, the structural deficit is not projected to improve before 2009. There are risks to the achievement of the budgetary targets after 2008 and the MTO might not be reached by the end of the programme period. Government debt would approach the 60 % of GDP reference value in 2007 and continue to decline in subsequent years."

In view of its assessment, the Council invited Austria to "exploit the good economic conditions and the lower-than-targeted deficit in 2006 to frontload and strengthen the adjustment in 2008 and to continue the fiscal consolidation towards the MTO thereafter, in particular by rigorously implementing expenditure restraint and by using any unexpected tax revenues for consolidation".

## 2.2. Orientations for budgetary policies adopted by the Eurogroup in April 2007

On 20 April 2007, with a view to improving the coordination of fiscal policies in the euro area, Eurogroup ministers discussed national budgetary developments in 2007 and the preliminary policy outlook for 2008 and their implications for the euro area.

Reaffirming their adherence to the sound fiscal policy principles of the revised Stability and Growth Pact and to national fiscal rules, Ministers committed to (i) build on the better-than-expected budgetary outcomes in 2006 to pursue more ambitious budgetary targets than those set in the end-2006 updates of the stability programmes; (ii) implement their 2007 budgets as planned, avoiding expenditure overruns, and using unexpected extra revenues to reduce government deficit and debt; and (iii) carefully design fiscal policy plans for 2008 so as to accelerate the adjustment towards the MTO for Member States which have not reached it and for those which have reached it to avoid feeding macroeconomic imbalances overall[2].

## 2.3. March 2007 update of the country-specific broad economic policy guidelines in the area of budgetary policies

On 27 March 2007, the Council adopted a recommendation on the 2007 update of the broad guidelines for the economic policies of the Member States and the Community and on the implementation of Member States' employment policies[3]. In the area of budgetary policies, Austria was encouraged to focus on achieving the target of a balanced budget in 2008. In addition, all euro area Member States were recommended to "make use of the favourable cyclical conditions to aim at or pursue ambitious budgetary consolidation towards their medium-term objectives in line with the Stability and Growth Pact, hence striving to achieve an annual structural adjustment of at least 0.5 % of GDP as a benchmark" and "to improve the quality of public finance by reviewing public expenditures and taxation, with the intention to

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2 The entire statement can be found at: www.gouvernement.lu/salle_presse/actualite/2007/04/20pm_krecke_berlin/MTBR_EG_conclusions-finalCLEAN.rtf

3 OJ L 92, 3.4.2007, p. 23.

enhance productivity and innovation, thereby contributing to economic growth and fiscal sustainability".

### 2.4. The Commission assessment of the October 2007 implementation report of the national reform programme

On 11 December 2007, the Commission adopted its Strategic Report on the renewed Lisbon strategy for growth and jobs, which includes an assessment of the October 2007 implementation report of Austria's national reform programme[4].

Austria's national reform programme identifies the following as key areas: sustainability of public finances, labour market and employment, R&D and innovation, infrastructure, business environment, education and training, as well as environmental and resource management. The 2007 implementation report added "social security system as productive force" as the eight priority. The Commission's assessment was that Austria has made significant progress in implementing its national reform programme over the 2005-2007 period.

Against the background of strengths and weaknesses identified and the evidence on progress made, the Commission recommended that Austria is recommended to give highest priority to the challenges in increasing the employment rate of older workers and improve education outcomes for vulnerable youth. In addition, Austria should also focus on the areas of: fiscal consolidation (to achieve a balanced budget by 2010); competition in services (in particular in professional services); entrepreneurship education; environmental protection; and gender segregation of the labour market.

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[4] Communication from the Commission to the European Council, "Strategic report on the renewed Lisbon strategy for growth and jobs: launching the new cycle (2008-2010)", 11.12.2007, COM(2007)803.

**Box: Main points covered by the assessment**

As required by Article 5(1) (for stability programmes) and Article 9(1) (for convergence programmes) of Council Regulation (EC) No 1466/97, the assessment covers the following points:

- whether the economic assumptions on which the programme is based are plausible;
- the medium-term budgetary objective (MTO) presented by the Member State and whether the adjustment path towards it is appropriate;
- whether measures being taken and/or proposed to respect that adjustment path are sufficient to achieve the MTO over the cycle;
- when assessing the adjustment path towards the MTO, whether a higher adjustment effort is made in economic good times, whereas the effort may be more limited in economic bad times, and, for euro-area and ERM II Member States, whether the Member State pursues an annual improvement of the cyclically-adjusted balance, net of one-off and other temporary measures, of 0.5% of GDP as a benchmark to meet its MTO;
- when defining the adjustment path to the MTO (for Member States that have not yet reached it) or allowing a temporary deviation from the MTO (for Member States that have), the implementation of major structural reforms which have direct long-term cost-saving effects (including by raising potential growth) and therefore a verifiable impact on the long-term sustainability of public finances (subject to the condition that an appropriate safety margin with respect to the 3% of GDP reference value is preserved and that the budgetary position is expected to return to the MTO within the programme period), with special attention for pension reforms introducing a multi-pillar system that includes a mandatory, fully-funded pillar;
- whether the economic policies of the Member State are consistent with the broad economic policy guidelines.

The plausibility of the programme's macroeconomic assumptions is assessed by reference to the Commission services' autumn 2007 forecast, using also the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances.

The assessment also examines:

- the evolution of the debt ratio and the outlook for the long-term sustainability of the public finances, which should be given "sufficient attention in the surveillance of budgetary positions" according to the Council report of 20 March 2005 on "Improving the implementation of the Stability and Growth Pact". A Commission Communication of 12 October 2006 sets out the approach to the assessment of long-term sustainability[5];
- the degree of consistency with the national reform programme, submitted by Member States in the context of the Lisbon strategy for growth and jobs, and its October 2007 implementation report. In its cover note of 7 June 2005 to the European Council on the broad economic policy guidelines for the period 2005-2008, the ECOFIN Council stated that the national reform programmes should be consistent with the stability and convergence programmes;
- compliance with the code of conduct[6], which inter alia prescribes a common structure and set of data tables for the stability and convergence programmes.

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[5] Communication from the Commission to the Council and the European Parliament, "The long-term sustainability of public finances in the EU", 12.10.2006, COM (2006) 574 final and European Commission, Directorate-General for Economic and Financial Affairs (2006), "The long-term sustainability of public finances in the European Union", European Economy No 4/2006.

[6] "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.

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**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 of Austria, 2007-2010**

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[7], 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:

(1) On [4 March 2008] the Council examined the updated stability programme of Austria, which covers the period 2007 to 2010.

(2) Over the last few years, Austria has experienced robust economic growth, surpassing that of other euro area countries on average. With private consumption being sluggish, the main contributions to growth came from net exports and investment. Continued wage moderation helped to maintain price stability while boosting external competitiveness. The Austrian labour market has been performing well, with the unemployment rate being one of the lowest in the EU and the overall employment rate higher than the 70% targeted by the Lisbon strategy. However, the employment rate of older workers remains well below the EU average. With public debt in excess of 60% of GDP, the general government deficit has been declining since 2005, but the achievement of a balanced budget has been repeatedly postponed. Lasting consolidation of public finances will hinge mainly on an overhaul of fiscal relations between different government levels as the present ones are overly complicated and lack transparency.

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7 OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). The documents referred to in this text can be found at the following website: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

(3) The macroeconomic scenario underlying the programme envisages that real GDP growth will decelerate from 3.4% in 2007 to 2.5% on average over the rest of the programme period. Assessed against currently available information[8], this scenario appears to be based on plausible growth assumptions. Given the latest developments in food and oil prices, inflation could turn out somewhat higher than projected in the programme, but the continued wage moderation should contribute towards maintaining high degree of competitiveness.

(4) For 2007, the general government deficit is estimated at 0.7% of GDP in the most recent update of the stability programme, against a target of 0.9% of GDP set in the previous update. This improvement over the target results mainly from the better-than-expected cyclical developments, with revenue exceeding the budgetary plans and slightly offsetting higher-than-planned expenditure growth. In particular, proceeds from personal and corporate income tax as well as interest income tax gave rise to the higher-than-planned revenue. Overall, budgetary implementation in 2007 could be considered broadly in line also with the April 2007 Eurogroup orientations for budgetary policies.

(5) The main goal of the medium-term budgetary strategy is to reach the medium-term objective (MTO) - a balanced position in structural terms (i.e. in cyclically-adjusted terms net of one-off and other temporary measures) - by 2010. The headline general government balance is planned to swing from a deficit of 0.7% of GDP in 2007 to a 0.4% of GDP surplus in 2010, with a back-loaded adjustment. The primary surplus is expected to improve somewhat less - by 0.9 percentage points of GDP - during the period. The structural deficit, calculated according to the commonly agreed methodology, will narrow by about 1 percentage point of GDP between 2007 and 2010[9]. The consolidation relies largely on expenditure cuts, with restraint in social spending and gains from administrative reforms being the main factors. Compared with the previous programme, which envisaged that the MTO would be nearly reached in 2009, the new update slightly backloads the planned adjustment despite a more favourable growth performance in 2007. Government gross debt, estimated at the 60% of GDP Treaty reference value in 2007, is projected to decline by 4.5 percentage points over the programme period.

(6) The risks to the budgetary projections in the programme appear broadly balanced for 2008, but for 2009 and 2010 the budgetary outcomes could be worse than projected, despite plausible macroeconomic assumptions. In particular, the programme does not provide sufficient information about the measures that are necessary to underpin the significant expenditure restraint envisaged in the last two years of the programme, although savings on unemployment benefits and on pensions, as a result of the 2004 pension reform, should contribute to the decline in the expenditure ratio. It is also not clear how the expenditure targets allow for the planned additional spending on education, R&D and infrastructure over the programme period, while the expected efficiency gains in public administration remain uncertain. Finally, the programme

[8] The assessment takes notably into account the Commission services' autumn forecast and the Commission assessment of October 2007 implementation report of the national reform programme.

[9] If one treated the additional expenditure for military equipment as a one-off measure (which the programme does as reported in the overview table below, even though the Commission services do not), the adjustment in structural deficit would be by 0.2 percentage point lower than if these one-off measures are disregarded.

announces tax cuts for 2010 without making any provision for financing them. The risks to the projected evolution of the debt ratio appear to be broadly balanced, with on the one hand potentially higher-than-targeted deficits endangering adherence to the adjustment path presented in the programme, but on the other hand, nominal GDP possibly turning out higher than foreseen.

(7) In view of this risk assessment, the budgetary stance in the programme may not be sufficient to ensure that the MTO is achieved by 2010, as envisaged in the programme. However, a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations will be provided throughout the programme period. In 2008, the pace of adjustment towards the MTO implied by the programme is insufficient and should be strengthened significantly to be in line with the Stability and Growth Pact, which stipulates that the annual improvement in the structural balance should be higher than 0.5% of GDP in good economic times. The pace of adjustment in 2008 is also not in line with the April 2007 Eurogroup orientations for budgetary policies. After 2008, the planned adjustment should be backed up with specific expenditure-saving measures.

(8) Austria appears to be at low risk with regard to the sustainability of public finances. The long-term budgetary impact of ageing is lower than the EU average, with pension expenditure projected to decrease as a share of GDP over the long term. The budgetary position in 2007 as estimated in the programme, which is better than the starting position of the previous programme, contributes to easing the projected long-term budgetary impact of ageing populations. Maintaining high primary surpluses over the medium term, as planned in the programme, would further contribute to limiting risks to the sustainability of public finances.

(9) The stability programme is fully consistent with the October 2007 implementation report of the national reform programme. Focussing on the measures with a direct budgetary impact, both the stability programme and the implementation report provide for a shift in spending towards growth-orientated categories, such as R&D, infrastructure and education. Likewise, the implementation report contains information on the reforms of the public administration, health care system, as well as on the introduction of a new medium-term budgetary framework, all of which are key elements of the budgetary consolidation path presented in the stability programme.

(10) The budgetary strategy in the programme is only partly consistent with the country-specific broad economic policy guidelines included in the integrated guidelines and the guidelines for euro area Member States in the area of budgetary policies issued in the context of the Lisbon strategy, as the structural improvement towards the MTO does not appear to be sufficient.

(11) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme provides all required and most of the optional data[10].

[10] In particular, the data on some components of the stock-flow adjustment as well as some items on long-term sustainability are not provided.

The overall conclusion is that in a context of growth remaining close to its potential, the programme envisages slow progress towards the MTO through a relatively back-loaded adjustment that is based on not-fully-specified expenditure restraint. There are risks to the achievement of the budgetary targets after 2008 and the MTO might not be reached by the end of the programme period. The update makes no provision for financing the tax cuts announced for 2010. Government debt is expected to have decreased to the 60% of GDP reference value in 2007 and to continue to decline moderately in future years. In terms of long-term sustainability of public finances, Austria appears to be at low risk.

In view of the above assessment and also in the light of the April 2007 Eurogroup orientations for fiscal policies, Austria is invited to take advantage of the slightly lower-than-targeted deficit outcome in 2007 to strengthen the adjustment effort in 2008 as well as to underpin the adjustment planned for the two final years of the programme with specific and sufficient measures. In this way, the MTO should be achieved earlier than foreseen in the programme, in particular by more rigorously implementing expenditure restraint and by using any unexpected tax revenues for budgetary consolidation.

## Comparison of key macroeconomic and budgetary projections

| | | 2006 | 2007 | 2008 | 2009 | 2010 |
|---|---|---|---|---|---|---|
| Real GDP (% change) | **SP Nov 2007** | **3.3** | **3.4** | **2.4** | **2.5** | **2.5** |
| | COM Nov 2007 | 3.3 | 3.3 | 2.7 | 2.4 | n.a. |
| | *SP Mar 2007* | *3.1* | *2.7* | *2.3* | *2.5* | *2.6* |
| HICP inflation (%) | **SP Nov 2007** | **1.5** | **1.9** | **2.0** | **2.0** | **2.0** |
| | COM Nov 2007 | 1.7 | 1.9 | 1.9 | 1.8 | n.a. |
| | *SP Mar 2007* | *1.5* | *1.6* | *1.7* | *1.7* | *1.8* |
| Output gap[1] (% of potential GDP) | **SP Nov 2007** | **-0.5** | **0.4** | **0.4** | **0.5** | **0.5** |
| | COM Nov 2007[2] | -0.4 | 0.4 | 0.8 | 0.8 | n.a. |
| | *SP Mar 2007* | *-0.3* | *0.1* | *-0.1* | *0.1* | *0.3* |
| Net lending/borrowing vis-à-vis the rest of the world (% of GDP) | **SP Nov 2007** | **3.2** | **3.5** | **3.7** | **3.7** | **3.7** |
| | COM Nov 2007 | 3.3 | 4.6 | 5.2 | 5.3 | n.a. |
| | *SP Mar 2007* | *n.a.* | *n.a.* | *n.a.* | *n.a.* | *n.a.* |
| General government balance (% of GDP) | **SP Nov 2007** | **-1.4** | **-0.7** | **-0.6** | **-0.2** | **0.4** |
| | COM Nov 2007 | -1.4 | -0.8 | -0.7 | -0.4 | n.a. |
| | *SP Mar 2007* | *-1.1* | *-0.9* | *-0.7* | *-0.2* | *0.4* |
| Primary balance (% of GDP) | **SP Nov 2007** | **1.5** | **2.0** | **2.1** | **2.3** | **2.8** |
| | COM Nov 2007 | 1.4 | 1.7 | 1.8 | 2.0 | n.a. |
| | *SP Mar 2007* | *1.9* | *2.0* | *2.1* | *2.6* | *3.1* |
| Cyclically-adjusted balance[1] (% of GDP) | **SP Nov 2007** | **-1.2** | **-0.9** | **-0.8** | **-0.4** | **0.1** |
| | COM Nov 2007 | -1.2 | -1.0 | -1.0 | -0.8 | n.a. |
| | *SP Mar 2007* | *-1.0* | *-0.9* | *-0.7* | *-0.2* | *0.2* |
| Structural balance[3] (% of GDP) | **SP Nov 2007** | **-1.2** | **-0.7** | **-0.6** | **-0.4** | **0.1** |
| | COM Nov 2007 | -1.2 | -1.0 | -1.0 | -0.8 | n.a. |
| | *SP Mar 2007* | *-1.0* | *-0.8* | *-0.4* | *-0.2* | *0.2* |
| Government gross debt (% of GDP) | **SP Nov 2007** | **61.7** | **59.9** | **58.4** | **57.0** | **55.4** |
| | COM Nov 2007 | 61.7 | 60.0 | 58.4 | 57.2 | n.a. |
| | *SP Mar 2007* | *62.2* | *61.2* | *59.9* | *58.5* | *56.8* |

Notes:

[1]Output gaps and cyclically-adjusted balances according to the programmes as recalculated by Commission services on the basis of the information in the programmes.

[2]Based on estimated potential growth of 2.2% in 2006 and 2.4% in 2007-2009.

[3]Cyclically-adjusted balance excluding one-off and other temporary measures. According to the most recent programme one-off and other temporary measures are 0.2% of GDP in 2007 and 2008 and 0.1% of GDP in 2009; all deficit-increasing (spending on military equipment). There are no one-off and other temporary measures in the Commission services' autumn forecast as the Commission services do not consider this expenditure on military equimpent as a one-off.

Source :
*Stability programme (SP); Commission services’ autumn 2007 economic forecasts (COM); Commission services’ calculations*