The Impact of EU Accession on Austria's Budget Policy

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This paper analyzes Austria's budget policy prior to accession to the European Union (EU) and budgetary action taken to support the opening up of the domestic economy and its integration into the EU. Moreover, it assesses the impact that joining the European monetary union has had on Austria's fiscal strategy. The analysis reveals several regime changes over the past few decades: While the fiscal policy goal of the 1960s was, in essence, that of achieving a balanced budget, the government's commitment in the 1970s to developing the welfare state and to pursuing a stabilizing role in addition to its allocation function fundamentally changed the fiscal framework. The rapid rise in the debt ratio that ensued in the second half of the 1970s triggered a debate on the necessity of enforcing upper limits for budget deficits (as a percentage of GDP). This debate led to the proposition of the so-called Seidel formula, with which the federal government's budget deficit regained significance as a fiscal policy target. The government indeed responded to the rising interest payments on the spiraling debt with – heavily debated – consolidation measures. While EU accession as such in 1995 was not deemed to create substantial need for fiscal action, a general government deficit ratio in excess of 5% of GDP called for significant consolidation measures in its own right in 1996 and 1997 in order to ensure that Austria would be among the founding members of the euro area. The new coalition government coming into office in 2000 staged a fiscal policy turnaround in so far as it propagated the goal of a balanced general government budget, which was indeed reached in 2001. Yet given the ongoing weakness of the economy, the goal of achieving strictly balanced budgets has since been redefined into balancing the general government budget over the business cycle. With its decision to design another tax reform, not fully financed right away, Austria recently changed its fiscal policy strategy yet again, incurring a "temporary deviation" from the medium-term target under the Stability and Growth Pact.

1 Austria's Budget Policy before EU Accession (1960 to 1995)

In the 1960s, Austria's budget policy was aimed at maintaining a balanced budget. The primary role assigned to government at the time was that of allocating resources to secure the provision of services of general economic interest and make sure that the essential needs of society would be met. While the public sector ran budget deficits in some years, it managed to keep the debt ratio stable at an exceptionally low level of just over 10% of GDP throughout the decade thanks to a negative interest rate-growth differential.

The 1970s were marked by "innovative" budget policies designed to finance the development of a welfare state along the lines of the Scandinavian model. These measures resulted in permanent budget deficits, which in turn caused the debt ratio to jump from 10% of GDP in 1974 to just below 50% of GDP in 1985.

Following the period of stagflation triggered by the first oil price shock, the government assumed a stabilization function on top of its allocation function; in other words, the state's economic role principally turned into that of a macropolitical agent (Mooslechner, 2001). The level of output and employment, previously considered largely exogenous to fiscal policy, now shifted to the center of macro politics, and the national budget took on a new and much larger strategic role in the framework of macroeconomic policy at large. While the expansionary course of fiscal policy and subsidies to state industries (which served as a policy instrument by providing employment) contributed to keeping the negative macroeconomic impact of the oil price shocks and of structural changes in Austria comparatively low,

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they also led to deficits, thus fueling the debt spiral.

The budget policy in combination with an exchange rate pegged to the Deutsche mark and an incomes policy geared to containing costs through trade union wage restraint as well as the use of supply-side elements of tax policy (broad-based tax investment incentives) were aimed at maintaining full employment, the key policy objective at the time. This Austrian brand of Keynesianism was in fact a success as it managed to contain unemployment. At the same time, it created major structural problems, for instance through the subsidization of the state industries. The appearance of early retirement packages at the beginning of the 1980s also dampened unemployment, yet at the cost of higher transfer payments from the social security budgets. In essence, Austria's budget policy in this period primarily aimed at preventing unemployment from rising rather than at ensuring long-term sustainability.

The cumulative deficits and off-budget measures caused the debt ratio to soar in the second half of the 1970s. Unlike in the 1960s, when a negative interest rate-growth differential had helped stabilize the debt ratio, the interest rate-growth differential turned positive in the 1970s. In other words, Austria would have had to achieve primary surpluses to be able to keep the debt ratio stable.

The soaring debt ratio triggered a debate about the necessity of enforcing upper limits for the budget deficits (as a percentage of GDP). Hans Seidel, then director of the Austrian Institute of Economic Research (WIFO) developed the so-called Seidel formula based on the theoretical model of Domar. According to this formula, Austria would have had to target a federal government deficit of 2½% of GDP on average in order to stabilize the debt ratio at a level of one-third of the output volume, given annual nominal growth rates of 7%.

Thus, the federal government's budget deficit regained significance as a fiscal policy target. The implementation of the Seidel formula had a number of practical consequences. First, whenever the budget deficit exceeded the Seidel threshold by a certain margin, consolidation packages were adopted with a view to reducing the deficit in the following years. To keep the political costs of such measures as low as possible, more and more public sector tasks were taken off the administrative budget, or new tools (such as state guarantees) were created that were not recorded in the budget accounts. Furthermore, public expenditure was deferred to postpone the build-up of budget deficits (outlays for state pensions and public sector employees, whose pay schedule is based on the seniority principle, being cases in point). Yet primary surpluses remained out of reach even despite these measures.

The consolidation measures undertaken in response to the higher interest payable on the spiraling debt became the subject of a fierce policy debate because "in the wake of the fiscal mentality change" (Bartel, 1993) in the 1970s policymakers in Austria, too, had embraced the idea that high and rising budget deficits were in fact politically feasible and economically viable. Jettisoning these beliefs, the coalition government of Social Democrats and Conservatives coming into office in 1987 agreed on tackling the consolidation of the federal budget as a key objective of economic policy, given the path on which the federal budget was developing and the impact it was

having on other policy areas (growth, employment, distribution, exchange rate) (Arbeitsübereinkommen, 1987). This re-reorientation of budget policy implied the de facto departure from the Austro-Keynesian course and a partial move to supply-side economics (Bartel, 1995).

The shift to broadly supply-side fiscal and economic policies led to the launch of two comprehensive tax reforms in 1989 and 1994. These reforms reflected concerns about the negative effects high tax burdens were having on investment and long-term growth as well as the recognition that the conditions for taxation had changed through the progressive opening up of borders and the liberalization of capital movements. By discarding the system of comprehensive income taxation, these tax reforms also reflected the departure from strictly distributional objectives based on the ability-to-pay principle of taxation.

Among other things, the government reduced the marginal income tax rate from 62% to 50%. This step, which above all dampened tax progressivity for middle- and higher-income brackets, was meant to create stronger incentives to work. The reform of capital taxation in a broader sense (Austria introduced a comparatively low proportional tax rate for corporations while expanding the tax base as well as a proportional tax on residential taxpayers' capital income that is withheld at source and treated as a final tax) was aimed at better positioning Austria in the competition for portfolio and real investment as well as at improving its attractiveness as a business location. The tax reforms of this period were thus a response to the opening up of the economy and the free movement of capital and labor as well as to the growing location competition, as a result of which policymakers had considerably less leeway for taxing capital than for taxing labor.

2 EU Accession

Austria applied for EU accession in July 1989. Initial negotiations were carried out at the level of the European Free Trade Association (EFTA) and the European Economic Community (EEC), as a result of which the European Economic Area (EEA) was established on January 1, 1993.

EU accession as such created comparatively little need for fiscal action.[2] The immediate impact on tax legislation in Austria was found to be rather low. Much rather, needs to adjust the tax regime and restrictions of the room for maneuver tended to result from the opening up of borders and from the liberalization of capital, labor, goods and services markets as well as from the increasing tax base mobility. In anticipation of a possible later EU membership, value-added taxation (VAT) had been introduced in Austria already in 1973 and had since turned into the biggest source of tax revenues.[3] Moreover, the higher VAT rate for luxury goods, introduced in 1977 with a view to containing a twin deficit, had been abolished in 1992 when EU accession was coming within closer reach (except for purchases of motor vehicles, for which it was retained as an environmental tax).

[2] *See Nitsche et al. (1988).*

[3] *The EU's Internal Market program was aimed directly at harmonizing VAT rates and specific excise duties. Agreement on a broadly uniform basis of assessment for this tax category was achieved already with the Sixth VAT Directive of 1977. After all, Community expenses are financed among other things through a share of the national VAT revenues of the Member States equivalent to 1.4% of the agreed basis of VAT assessment.*

The need for adjustment arose in the following areas: loan taxation had to be adjusted, taxes similar to VAT had to be abolished and specific services, such as medical services, had to be made exempt from VAT. In the field of excise duties, petroleum taxes had to be raised under the regulation implementing the VAT Directive. Moreover, the road transport duty had to be cut substantially. At the same time, it was clear that Austria was going to be a net contributor to the EU budget. This implied that EU accession would create a net burden for Austria's budget equivalent to 0.9% of GDP in the medium term and to 1½% of GDP in the first year according to initial WIFO[4] calculations. Yet none of the numerous studies on Austria's EU accession discussed the issue that the requirement to meet the Maastricht criteria might cause budget problems. After all, Austria had successfully complied with a Maastricht deficit ratio of 3% of GDP on average in the 1980s. The debt ratio, too, was close to the Maastricht reference value of 60% of GDP; besides, this criterion appeared to be of secondary importance because it was seen as broadly driven by deficit developments.[5]

Apart from a large part of agricultural policies, the provisions of the EU's Internal Market program had already been implemented upon Austria's accession to the EEA. Thus, domestic markets for goods and services were no longer protected from external competitors, and EU competition rules had already become binding. In certain areas EEA membership had required the disclosure of previously hidden subsidies and the disclosure of the financing burden in the government accounts.[6] Upon EU accession on January 1, 1995, agricultural subsidies had to be largely disclosed as well. Subsidies had, incidentally, been raised considerably in the run-up to EU accession with a view to enabling the sectors concerned to better cope with the looming pressures of competition.

In the light of the public referendum on EU entry, the federal government tried to compensate the potential losers of EU accession with budgetary funds. As a result, the budget deficit jumped to a record high of 5.7% of GDP in 1995, well above the Maastricht reference value of 3% of GDP.

3 Preparations for Monetary Union Membership: Budget Policy in 1996 and 1997

At the European Council summit in Maastricht on December 10, 1991, the heads of state or government of the 12 EEC countries reached an agreement on the draft Treaty on European Union.[7] The Treaty stipulated that the second stage of Economic and Monetary Union (EMU) was to start on January 1, 1994, after all restrictions

[4] *See Bayer et al. (1994).*

[5] *"In terms of budget ratios, price stability and interest rate levels, Austria is among the core countries of a future economic and monetary union" (quote from the finance minister's budget speech 1994).*

[6] *Austria had seen a number of interventions recorded on off-the-books accounts that basically aimed at protecting the Austrian market from imports and regulated domestic prices. The cost of administered prices had to be borne by consumers in the form of a loss of the consumer's surplus, while the burden of the required compensatory subsidies and adjustment assistance had to be borne by the tax community.*

[7] *The Treaty on European Union was signed in Maastricht on February 7, 1992, and entered into force on November1, 1993.*

on the movement of capital between EU Member States had been abolished and the Internal Market had been implemented in the first stage (starting on July 1, 1990).

In the second stage of EMU, Member States stepped up their efforts to achieve nominal convergence by complying with the criteria for joining the monetary union, i.e. the Maastricht criteria.[8] Under the Maastricht Treaty, compliance with budgetary discipline is to be examined on the basis of two reference values that both reflect policy choices: the general government deficit ratio of a Member State shall, as a rule, be below 3% of GDP, and the general government debt ratio shall be below 60% of GDP (or have declined substantially and continuously and reached a level that comes close to the reference value). Moreover, the treaty enshrined the prohibition of monetary financing of government debt and a "no bailout" clause in order to prevent moral hazard behavior. The European Council agreed that only those countries would be able to move to the third stage of EMU that actually met the Maastricht criteria.

Under the Maastricht Treaty, the third stage of EMU was to begin in 1997 at the earliest provided the majority of the Member States fulfilled the necessary conditions for the adoption of a single currency by then. However, this was not the case. The Madrid European Council eventually confirmed in December 1995 that January 1, 1999, would be the starting date for the third stage of EMU. Those EU Member States that met the convergence criteria in 1997 would be able to participate.

For Austria's government it was of paramount political importance to be among the initial members of the euro area. Against this backdrop, the finance minister first of all decided to change budget accounting from the "administrative budget" framework prescribed by the Federal Budget Act to the framework of the European System of National Accounts (ESA) used for the Maastricht criteria. Before, ESA measures had been used primarily for national accounts calculations of GDP and for reports to international institutions, such as the OECD and the IMF. The key difference between the administrative budget deficit or surplus and the corresponding ESA-based figures arises from the accrual method of accounting used to record income and expenditures under ESA. Under the administrative method, it had been possible, among other things, to smooth out cyclical fluctuations by transferring funds from or to reserves. With the ESA framework, this was no longer an option.[9]

The political will to be among the first group of monetary union participants implied the need to meet the Maastricht criteria. In January 1996, it became evident that the deficit ratio had jumped to more than 5% of GDP in 1995 from 1.9% of GDP in 1992. The cyclically adjusted deficit ratio for 1995 lay even ½ percentage point above this ratio. At the same time, the debt ratio had risen from 58.3% (1992) to 69.4% (1995) of GDP. Without any countermeasures the deficit would have increased further to some 7% of GDP, and the debt ratio would have soared, too. The budget dynamics

[8] *These criteria were and are: deficit ratio of below 3% of GDP, debt ratio of below 60% of GDP (if the debt ratio is above 60%, it must have declined substantially and continuously and reached a level close to 60%), low inflation, low interest rates, two-year membership in the exchange rate mechanism (ERM).*

[9] *In fact, deviations from the accrual principle used in ESA are possible in certain cases for reasons of practicality, for instance when accounting for direct taxes. See Fleischmann (2002) for an overview of the conceptual differences.*

in Austria from 1993 to 1995 were alarming, compared with developments in previous years and in other EU countries (Van der Bellen, 1997).

As a result, the Austrian government put together the biggest consolidation package in the post-War period. With a consolidation volume of about 4% of GDP to be achieved within a period of less than two years, this package was also the comparatively biggest consolidation drive in the EU.[10] Given the record expenditure ratio Austria had reached, spending cuts were designed to account for two-thirds of the consolidation success and revenue increases for one-third. These consolidation measures reduced the disposable income of households by close to 10% on average, but the reform had been designed to take more money out of the wallets of higher earners. Other key measures included the reduction of staff numbers in the public sector, the reclassification of government enterprises to the private sector and a pension reform package to be launched in 1997. Furthermore, the government expanded the definition of taxable income significantly, but left nominal tax rates unchanged and also refrained from increasing nonwage labor costs. In 1996, the federal government negotiated a precursor of today's Austrian Stability Pact with the provinces and municipalities. Laws enforcing this Pact and implementing a consultation mechanism were adopted in 1999. This framework was meant to prevent the individual layers of government from shifting the budget burden to one of the other layers. Thus, the provinces and municipalities had to produce a so-called stability contribution from 1996 onward.

Economists were skeptical about the feasibility and economic sense of this consolidation drive. After all, given expectations of real GDP growth of approximately 2% in 1996 and 1997, there was little leeway for budget consolidation if a recession was to be avoided. Macro model simulations were indicating significant growth setbacks.[11] How big the growth effect of consolidation was in the end, and how big an effect can be attributed to the speed with which it was implemented is difficult to estimate. Austria recorded a real (cumulative) growth of 4.5% in 1996 and 1997, compared with 2.2% for Germany and 4.2% for the EU-15 average. This implies that "non-Keynesian" effects of budget consolidation may have been at work, whose existence is, however, a matter of controversy among economists (Prammer, 2004).

In 1996, for the very first time, the government also formulated an explicit strategy for lowering the debt-to-GDP ratio since forecasts indicated that this ratio would keep rising in the medium term despite budget consolidation measures.[12] Specifically, the government envisaged trimming the debt ratio by reclassifying government enterprises to the private sector, selling loan receivables of the Umwelt- und Wasserwirtschaftsfonds (environ-

[10] *With regard to EU comparisons, note that countries with bigger consolidation successes broadly benefited from the convergence of interest rates, which translated into savings of up to 5% of GDP. Moreover, the allocations made in current time series, based on Maastricht definitions, do not match the allocations made according to earlier provisions.*

[11] *According to Breuss et al. (1997) the demand-side consolidation measures permanently reduced the level of GDP by 1.2% in 1996. While consolidation would have had to be undertaken even without participation in the monetary union, a longer consolidation period would have had lower negative effects.*

[12] *See Austrian Convergence Programme of May 1996.*

ment and water management fund), undertaking portfolio shifts and restructuring fee-based municipal services to turn them into market producers. To this effect, the government also sold its stakes in the large banks Creditanstalt-Bankverein and Bank Austria AG, and slated the Austrian Postal Savings Bank P.S.K., the tobacco manufacturer Austria-Tabak-Werke AG and the salt producer Österreichische Salinen AG for privatization.

Apart from privatizing state holdings, the government also sold financial assets, for instance assets of the Umwelt- und Wasserwirtschaftsfonds, and made plans to sell unused property. Other measures were aimed at the Austrian highway authority ASFINAG and the Straßenbausondergesellschaften (high-speed road construction companies), whose debt totaled approximately EUR 5.7 billion at the end of 1996. In order to reach a refinancing level of 50% through user fees, the precondition for reclassification to the private sector,[13] the tasks of ASFINAG (which had initially been established as a financing agency) were expanded to include road construction and maintenance; the companies responsible for the high-speed road network were reorganized. Moreover, an electronic road pricing system, with charges based on kilometers traveled, was to be introduced throughout Austria by 2001.[14] In addition, the municipalities committed themselves to restructuring their market services and fee-based utilities (water and wastewater utilities, refuse collection, residential and commercial development) in such a way that their debt shares would no longer count toward the public debt ratio in line with ESA 95 provisions.

4 Heavily Criticized "Consolidation Pause" (1998 to 2000)

The reduction of the Austrian general government budget deficit below the Maastricht reference value and compliance with the other Maastricht criteria in 1997 paved the way for monetary union membership. Yet the strong consolidation efforts after 1995 were followed by a "consolidation pause" from 1998 onward. The Stability Programme of 1998 targeted a deficit ratio of 1.5% of GDP by 2002, which only roughly provided for the cyclical safety margin Austria was supposed to maintain with a view to avoiding an excessive deficit. Since the necessary reform measures were left largely untackled, the medium-term target of a balanced budget required under the Stability and Growth Pact was not achieved. The government failed to use the favorable economic climate in the period from 1998 to 2000 to step up consolidation efforts. In fact, the deficit ratio even resurged significantly in 1998.[15] Yet in view of the parliamentary elections forthcoming in 1999, the government designed another – procyclical – tax reform, due to take effect in 2000, resulting in a net revenue shortfall of approximately 0.9% of GDP that was not going to be financed by spending cuts. Furthermore, the reform of family benefits, triggered by a Constitutional Court ruling, put an additional burden of 0.25% each on the budgets

[13] *As a result, the ASFINAG debt no longer counted toward public sector debt.*

[14] *In fact, such a system was not implemented until 2004.*

[15] *The consolidations of the previous years were also partly based on one-off measures and temporary measures, expiring in 1998, such as the temporary abolition of loss carryovers. This caused the budget situation to deteriorate automatically in 1998. The deterioration of the general government deficit also reflects higher investment outlays by the municipalities following years of spending restraint.*

of 1999 and 2000. As a result, Austria dropped to the bottom of the deficit ratio ranking of the EU Member States.

Despite all the consolidation measures, Austria's expenditure ratio remained comparatively high, with outlays for personnel, pensions and health care continuing to increase in particular. To some extent the high and rising expenditure ratio is attributable to the fact that sweeping reforms, which would have slowed down the trend growth of these large and dynamic expenditure aggregates, had again and again been postponed, and that those economic reforms that were launched were not embraced wholeheartedly. Hardly surprising, international institutions (IMF, European Commission, Ecofin Council) called upon Austria to reconsider the size of the public sector, to reinforce privatization (Austria Tabak GmbH & CoKG, P.S.K., Post- und Telekom Austria AG) and deregulation (electricity and gas supply) and to implement sustained cost saving measures in particular in the public sector as well as sustained pension and healthcare reforms.

The debt ratio actually followed a downward path in 1996 and 1997 because primary surpluses were achieved, the interest rate growth differential improved as interest rates dropped and privatization proceeds could be used to pay down debt.[16] Yet in 1998 the debt path reversed as well.

5 New Coalition Government Committed to Balancing the Budget, Downsizing the Public Sector and Improving Austria's Attractiveness as a Business Location (2000 to 2005)

The tax reform entering into force in January 2000 was already "inspired" by the EU's Broad Economic Guidelines (apart from the fact that it was not financed with spending cuts).[17]

The new coalition government coming into office in February 2000 redefined Austria's fiscal strategy substantially. In March 2000, the government submitted an update of the Stability Programme to the European Commission that listed new measures adding up to a medium-term consolidation effect of 1.2% of GDP. Cuts in discretionary expenditure, further cuts in public sector employment as well as reductions in pension and transfer payments (other than child benefits, which were in fact increased) motivated by a "reprioritization to reach those most in need" on the expenditure side, as well as the proceeds from UMTS license auctions and a first revenue-based consolidation package[18] contributed to further paring the deficit and keeping the cyclically adjusted deficit in 2000 at the level of 1999 after all. The lowering of the deficit ratio to 1.3% of GDP by 2003 and to 1% by 2005 announced in the

[16] *The proceeds from the sale of three mobile phone licenses in 1996 and 1997 corresponded to some 0.3% and 0.4% of GDP, respectively. Finally, the transfer of the P.S.K. pension reserves in 1997 in turn for which the state assumed the liability for future pension payments from the budget improved the budget balance by another 0.15% of GDP.*

[17] *The reform provided for higher tax credits for expenditure on research and development, apprenticeships and corporate training and development; tax concessions for start-ups; the possibility of deducting the notional return on capital from taxable income; inheritance and gift tax concessions for corporate successors; as well as exemptions from petroleum tax in turn for the use of ecologically sound fuels based on rape methyl ether. All in all, the income tax relief was estimated to total EUR 2.36 billion.*

[18] *In particular, the government raised the tobacco tax, the electricity surcharge, the motor vehicle insurance tax and individual fees (e.g. for passports and other official documents); these measures had a combined consolidation effect of approximately EUR 0.5 billion in 2000 and EUR 0.8 billion in 2001.*

March 2000 update of the Stability Programme was, however, heavily criticized by the Ecofin Council, as the Member States had agreed in the Broad Economic Guidelines to achieve the medium-term target of a balanced budget already by 2002.

In response to this criticism, the finance minister reprioritized Austria's budget polices in 2000, committing himself to reaching a balanced budget. This happened at a time when the room for maneuver had just been narrowed yet again, namely by the need to abolish the tax on beverages, found unconstitutional by the European Court of Justice, which corresponded to a revenue loss of 0.1% of GDP.[19]

In the December 2000 update of the Stability Programme, the government announced its intention to balance the general government budget by 2002 and in the years ahead, and to rapidly reduce the debt ratio to below 60% of GDP. To this effect the government adopted a second package, still in 2000, with a consolidation volume of 1% of GDP in the short run and 1.9% after three years (including the first package). The short-term measures included above all measures to increase tax revenues, while the medium-term measures largely relied on expenditure restraint. A sweeping pension reform (the biggest in the EU in terms of volume), even more staff cuts (also through early retirement schemes), moderate wage settlements, savings in overtime expenditures, an administrative reform and stronger efforts of the provinces and municipalities to generate cost savings were meant to help reach a balanced budget in 2002. These measures included, to some extent, further reclassifications of services provided by the provinces and municipalities and changes in the provincial subsidy and lending regimes. To make sure that the goal of a balanced budget would indeed be reached, a new domestic Stability Pact was signed, which committed the provinces and municipalities to making an active contribution; subject to the penalty of sanctions the provinces have since been required to produce surpluses, and the municipalities to record balanced budgets.

Above all a bigger than expected success of the revenue-increasing measures,[20] in particular the introduction of interest charges on outstanding tax liabilities, helped reach a slight surplus ahead of schedule in 2001. With the help of the two consolidation packages Austria had indeed managed to balance its budget – for the first time in 30 years.

The announcement to target a balanced budget from 2002 was welcomed above all by international institutions, such as the IMF and the Ecofin Council.[21] According to international

[19] *Moreover, the tax on stock transactions was abolished in the fall of 2000, and the annual tax credit for staff shares in capital was increased from EUR 727 to EUR 1,453; increases in the price of stock options were exempt from taxes up to an amount of EUR 36,336 and, to smooth out one-off losses, the limit for tax credits for the sale of shares was reduced from 10% to 1% of the company capital. Finally, the advertising tax rate was cut from 10% to 5%.*

[20] *Broadening of the income tax base, (one-off) increase of income tax prepayments, introduction of tuition fees for university students, abolition of premium-free coverage by the national health plan for childless nonworking spouses, rise of health insurance taxes for civil servants.*

[21] *At the same time, the high fiscal burden, the continued generous family benefit systems and the announcement to cut nonwage-related costs from 2003 met with criticism. The international institutions recommended to lower the fiscal burden, family transfers as well as housing and agricultural subsidies. Moreover, suggestions for a reform of the fiscal sharing plan have been put forth repeatedly, without ever being taken up.*

assessments, Austria's performance was perfect proof that the Stability and Growth Pact did work.

The other side of the medal was that Austria now recorded the highest fiscal burden in the post-War period. In 2002, the budget balance reversed into a moderate deficit, reflecting the significant slowdown in international economic activity in the second half of 2000 and the burden on public finances resulting from the aftereffects of exceptionally severe flood damages. These developments put a damper on budget revenues and prompted the government to implement two growth packages and one so-called growth and location package aimed at supporting growth in the short and in the medium run. These packages[22] were geared to the EU's Lisbon strategy and the measures recommended under this strategy for promoting growth.[23] In 2003, the general government deficit deteriorated to 1.1% of GDP, given the continued economic slowdown, the costs of the introduction of the new child-care benefits, the further increase of family allowance rates as well as the funding of the growth packages and of the growth and location package. The goal of achieving balanced budgets has since been replaced by the goal of balancing the budget over the business cycle. However, the pension reform of 2003 provided for another significant expenditure cut made with a view to improving the medium- to long-term sustainability of the pension system.

Securing long-term fiscal sustainability is a key policymaking goal within the EU in the face of the anticipated aging of Europe's citizens. To this effect, high debt ratios need to be rapidly cut back to a level of markedly below 60% of GDP and/or adequate pension reforms need to be implemented. This objective was first defined by the Economic Policy Committee of the EU in 1997. With regard to Austria, other international organizations had in fact called for such action even earlier, as had the members of the various pension reform committees (if in vain since the latest major pension reform implemented in 1983). Initial reform measures, though motivated by short-term budget consolidation endeavors, were set in 1997. The second stage of the reform, implemented in 2000, was also largely dominated by short-term considerations. Measures actually meant to ease the medium- to long-term burden on the pay-as-you-go state pension system were not introduced until the pension reform of 2003 and the harmonization of the prevailing pension systems from 2005 onward. In the field of health care, sweeping reform measures that

[22] *These measures included higher tax credits for research and development as well as training and education, more funds for public infrastructure projects (partly financed off-budget) as well as – under the second growth package – the introduction of a temporary 10% subsidy on investment in machinery, plant and equipment that exceeded the investment level of the past three years (originally designed to expire at the end of 2003; expanded until the end of 2004 under the growth and location package) and the increase of a number of tax credits introduced by the first growth package.*

[23] *The Lisbon strategy of the EU and its goal to make the EU the world's most dynamic and competitive economy by 2010 created new qualitative challenges for Austria's fiscal policy from 2000 to 2002. The challenges with the biggest quantitative impact are the requirement to, first, raise Austria's R&D ratio to 3% of GDP; second, to provide sufficient public child-care facilities; and third, to raise the development aid ratio. Other measures with an impact on the budget include the promotion of lifelong learning, the expansion of active labor market policies with a view to shortening placement periods and raising placement ratios, statutory obligations under the universal service regulations and the Kyoto protocol as well as payments to the EU budget.*

would guarantee the sustainability of the systems in the medium to long term have yet to be undertaken.

As mentioned above, the revenue-raising measures aimed at quick fiscal consolidation in 2001 drove up the fiscal burden to a level unprecedented in the post-War period. Hence the government coming into office in March 2003 agreed in its government program to reduce the fiscal burden to 40% by 2010 and announced a two-stage tax reform to this effect.

The first stage of this tax reform, implemented in 2004, changed the tax regime without actually lowering the fiscal burden, as it was accompanied by measures financing the reform. While raising excise duties was partly motivated by EU legislation, most of the measures were taken with national considerations in mind. The deficit remained broadly unchanged at 1.2% of GDP.

Measures to implement the second stage of the tax reform, designed to take effect in 2005, partly started ahead of schedule in 2004. Among other things, the corporate income tax rate was cut from 34% to 25% and group taxation was introduced. Both measures, which were noted internationally, may be seen as a reflex response to the fiercer competition for investors following EU enlargement. The second-stage measures were actually not fully financed and thus caused the budget deficit to newly deteriorate to some 2% of GDP. The ensuing – at least temporary – deviation from a balanced budget over the business cycle met with criticism from the Ecofin Council, which recalled the provisions of the prevailing Stability and Growth Pact. In addition, the government adopted measures aimed at broadly harmonizing the pension systems, with a view to improving their long-term fiscal sustainability. The goal to reachieve a balanced budget by 2008 was enshrined in the internal Stability Pact.

Austria's budget policy benefited from the low interest rate level in recent years, which made it possible to considerably reduce the average interest burden for the outstanding government debt over the years. Thus the debt ratio could be kept on a declining path, even if the annual average reductions of the debt ratio were rather minor. Following a Eurostat decision (beginning of 2003) the debt level jumped, as the federal government had to assume liability for any debt incurred under its intermediary funding program for public sector enterprises ("Rechtsträgerfinanzierung").[24]

To sum it up, Austria's budget policy has been broadly in line with the requirements of the European fiscal framework since 2001. While the government committed itself in March 2000 to pursuing a strict balanced budget goal that even went beyond the requirements of the Stability and Growth Pact, in response to international criticism, it replaced this target in 2002 with the goal of balancing the budget over the business cycle. The other key pillar of the course toward securing sound public finances as a condition for sustained development is the commitment to lower the fiscal burden to 40% of GDP by 2010. Finally, with a view to implementing the Lisbon strat-

[24] *The federal government provided lower-cost financing to finance state-owned enterprises by issuing bonds and relending the funds to those enterprises. The debt service costs had to be borne by the latter. In the case of the Austrian Railways, the federal government eventually also assumed the liability to service the debt.*

egy, the government has also strengthened the growth orientation of the budget and started to slash administration costs.

6 Summary

The budget policy pursued by Austria over the recent decades was marked by several regime changes. In the 1960s, Austria's budget policy was basically aimed at maintaining a balanced budget. The primary role assigned to government was that of allocating resources to secure the provision of services of general economic interest and to make sure that the essential needs of society would be met. The ensuing reinforced development of the welfare state along the lines of the Scandinavian model was accompanied by years of "innovative" budget policies. Yet the development of the welfare state and the stabilization function that fiscal policy assumed on top of its allocation function went hand in hand with permanent budget deficits, hovering mostly around the later 3% of GDP Maastricht threshold, and also led to a noticeable rise of the debt ratio.

Austria's accession to the EU at the beginning of 1995 as such was not seen as creating a need for fundamental fiscal policy action. However, the budgetary cost of EU accession in 1994/95 had been underestimated. Given a general government deficit ratio in excess of 5% of GDP, budget policymakers had to "pull the emergency break" in 1996/97 in order to ensure that Austria would be among the founding members of the euro area. Following this decision, the Maastricht criteria first became the official objectives of Austrian budget policy, superseding the federal government's "administrative" budget deficit as a target measure. Within the framework of the successive fiscal sharing negotiations (1997, 2001), a domestic Stability Pact was agreed. For the very first time, too, Austria undertook measures to consolidate the budget through spending cuts.

The adoption of the Stability and Growth Pact in 1997, finally, changed the fiscal policy course yet again, as this pact established a balanced general government budget as the new medium-term target of fiscal policy. In the light of a "consolidation pause" following the efforts of 1996/97, Austria failed to benefit from the favorable economic conditions from 1998 to 2000 to approach this target. Much rather, the government designed a credit-financed tax reform for 2000, which would invariably have caused Austria to exceed the Maastricht reference value of 3% of GDP at the very latest by 2001, given the economic slowdown.

The coalition government of Social Democrats and Conservatives was replaced by a coalition of the Conservative Party with the Freedom Party in 2000. The new government immediately implemented a fiscal "crash program" and a budget policy turnaround in so far as it propagated a balanced budget, which it in fact achieved in 2001, one year ahead of plan. In 2002, Austria was able to maintain its consolidation success, reaching a budget "close to balance." In the light of the ongoing economic setbacks, the goal of strict compliance with a balanced budget was, however, replaced by the goal of balancing the budget over the business cycle. With its decision to design another tax reform, not fully financed immediately, Austria moreover changed its fiscal policy strategy again, incurring a "temporary deviation" from the medium-term target under the Stability and Growth Pact.

The fiscal vision of the EU – and thus of the incumbent Austrian fiscal

policymakers – is basically the vision of achieving a lean and efficient state, with as little red tape as possible, built on moderate tax rates and a broad tax base. This should contribute to increasing the long-term growth potential of the Austrian economy, and of the other economies within the EU.

Austria's budget policy has changed considerably in the past decade. The political reorientation can be traced to EU membership, but not to the EU alone. It also came as a reaction to the further opening up of economies and the trend toward globalization. At the same time, it also reflects a change in preferences of Austrian voters and a change in the assessment of the role of the public sector and its functions.

Attributing the consolidation efforts made from the second half of the 1990s to accession to the EU and the euro area alone would not be justified, given the alarming budgetary developments seen from 1993 to 1995 (Van der Bellen, 1997). In view of these developments, Austria had no alternative to a consolidation strategy, as its fiscal policy was no longer going to be sustainable in the long term.

Annex

Development of General Government Fiscal Indicators

% of GDP

	Public expenditure (ESA 95)	Public revenues (ESA 95)	Public debt[1] [2]	General government fiscal balance (ESA 95)	General government fiscal balance (Maastricht)	Interest payments (ESA 95)
1960	×	×	13.7	–0.5	–0.5	×
1961	×	×	12.4	1.7	1.7	×
1962	×	×	12.0	1.2	1.2	×
1963	×	×	12.1	–0.5	–0.5	×
1964	×	×	12.0	0.5	0.5	×
1965	×	×	11.5	1.4	1.4	×
1966	×	×	10.9	1.8	1.8	×
1967	×	×	12.1	–0.6	–0.6	×
1968	×	×	13.0	–0.9	–0.9	×
1969	×	×	13.0	–0.1	–0.1	×
1970	×	×	12.5	1.2	1.2	×
1971	×	×	11.2	1.5	1.5	×
1972	×	×	10.4	2.0	2.0	×
1973	×	×	10.4	1.3	1.3	×
1974	×	×	9.9	1.3	1.3	×
1975	×	×	15.3	–2.5	–2.5	×
1976	49.0	45.4	17.9	–3.7	–3.7	1.7
1977	48.7	46.6	19.9	–2.2	–2.2	1.8
1978	51.9	49.2	22.8	–2.7	–2.7	2.2
1979	51.0	48.7	24.1	–2.4	–2.4	2.3
1980	51.3	49.6	36.1	–1.7	–1.7	2.4
1981	52.8	51.0	37.9	–1.8	–1.8	2.7
1982	53.4	50.0	40.3	–3.4	–3.4	3.0
1983	53.8	49.5	44.6	–4.3	–4.3	3.0
1984	53.9	51.2	47.0	–2.7	–2.7	3.3
1985	54.9	52.1	49.2	–2.8	–2.8	3.5
1986	55.8	51.9	53.9	–4.0	–4.0	3.6
1987	56.1	51.6	58.2	–4.5	–4.5	3.9
1988	53.7	50.3	57.6	–3.4	–3.4	3.8
1989	52.3	49.3	56.7	–3.0	–3.0	3.9
1990	52.0	49.6	56.1	–2.4	–2.4	4.0
1991	52.9	50.0	56.1	–2.9	–2.9	4.1
1992	53.6	51.7	55.8	–1.9	–1.9	4.2
1993	56.7	52.5	60.5	–4.2	–4.2	4.2
1994	56.2	51.3	63.4	–4.9	–4.9	4.0
1995	56.0	50.3	67.9	–5.7	–5.6	3.9
1996	55.4	51.4	67.6	–4.0	–3.9	3.9
1997	53.1	51.1	63.8	–2.0	–1.8	3.6
1998	53.4	51.0	64.3	–2.5	–2.3	3.7
1999	53.2	50.8	66.5	–2.3	–2.2	3.5
2000	51.4	49.8	65.8	–1.6	–1.5	3.7
2001	50.9	51.0	66.2	0.1	0.3	3.6
2002	50.6	50.2	65.8	–0.4	–0.2	3.4
2003	50.8	49.5	64.7	–1.3	–1.1	3.1
2004	50.7	49.4	64.2	–1.3	–1.2	3.0

Source: Statistics Austria, Austrian Federal Ministry of Finance.

As at April 2005.

[1]) The time series from 1960 to 1979 include only federal government debt; from 1980 the time series cover general government debt.

[2]) Debt ratio and GDP figures from 2001 reflect the recalculation of financial intermediation services indirectly measured (FISIM).

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