

## Economic Survey of Austria, 2003

### Summary

To raise Austria's growth potential, significant changes in the institutional set-up will be necessary in order to achieve sound public finances, higher labour force participation – in particular among older workers – and to open up the sheltered sectors of the economy to healthy competition. Although the government's emphasis on structural spending reductions to achieve eventual budget balance while also creating room for tax cuts is appropriate, earlier fiscal easing means that under current plans budget balance will be restored only after 2007. Such a deficit path is not appropriate given Austria's high debt-to-GDP ratio. Stronger spending restraint will be necessary in order to create room for the major tax reform that the authorities are committed to. Public expenditure reform is focused on reducing public sector employment, but the cost savings are eroded by the generous early retirement programmes used to achieve these employment reductions. Comprehensive public sector reform has to address the complicated -federal fiscal relationships and make sure that tasks are allocated to the most appropriate private or public agent. More cost-benefit analysis and output performance budgeting would help to improve the efficiency with which public resources are used. The pension reform undertaken by the government marks considerable progress in moving to sustainable old-age income replacement through measures designed to increase further the labour force participation rate of older workers and women and lengthen working lives considerably. Further necessary action includes measures to improve the employability of older workers, in particular the elimination of

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*This Policy Brief presents the assessment and recommendations of the 2003 OECD Economic Survey of Austria. The Economic and Development Review Committee, which is made up of the 30 member countries and the European Commission, reviewed this Survey. The starting point for the Survey is a draft prepared by the Economics Department which is then modified following the Committee's discussions, and issued under the responsibility of the Committee.*

excessive seniority wage components, and a more stringent revision of the remaining age-specific employment protection regulation. The large differences in economic performance between manufacturing, which is fully exposed to international competition, and services points to considerable scope for increasing competition by reducing entry barriers and facilitating the operations of the newly established competition authority. Proceeding along these lines will help Austria to realise the positive potential associated with Eastern enlargement while at the same time becoming more resilient to adverse supply side shocks. ■

### **Does Austria's economy need to adapt to changes in the economic environment?**

Austria has established a reputation as a well performing economy. Among the European countries, Austria belongs to the group of five with the highest GDP *per capita* since the end of the 1980s. Unemployment in Austria has been consistently at the lower end within the EU and the OECD. Yet, in recent years the Austrian growth performance has weakened relative to the other high-income countries and unemployment, while still being relatively low, has increased to levels hardly known in the past. The weakening of Austria's growth performance is largely reflected in weaker employment generation whose adverse effects were not offset by higher productivity growth.

Moreover, the country is facing challenges, some of which bring to the surface the need to renovate its hitherto successful institutional framework. While social partnership and a high degree of state intervention was beneficial during a protracted post-war period of structural stability and a high degree of state trade with non-market economies, this institutional set-up subsequently came under stress in the course of the appearance of supply shocks associated with globalisation and accelerating technological change. Within a more or less unchanged institutional framework, characterised by a large government sector and legally binding collective wage bargaining, important policy responses became more defensive during the 1990s: budget consolidation was achieved by an increase in the government revenue share of GDP to record levels; attempts were made to keep unemployment low by taking older workers out of the labour force; and enterprises producing for the domestic market were sheltered by some sophisticated entry

barriers, even after EU accession in 1995. While in recent years these problems have begun to be addressed, it is clear that Austria cannot continue along these lines and remain a prospering economy. Indeed, over the next years and decades the old age dependency ratio will substantially increase, with potentially adverse implications for growth and living standards. Also, while Austria has benefited from the opening of the eastern European Markets, reaping the full benefits of further integration requires that institutions and production processes are able to adjust rapidly. The priority targets for structural reform taken up in this *Survey* are to consolidate the general government budget, increase labour force participation and employment, and encourage higher productivity growth. The government is aware of these issues and has embarked on major reform efforts in order to reverse the slippage of Austrian economic performance. ■

### **Should fiscal consolidation rank high on the policy agenda?**

The target of balancing the general government budget was reached in 2001, one year earlier than originally scheduled. This was achieved mainly via revenue increases, without much spending restraint. In 2002 a small deficit re-emerged, totalling 0.2 per cent of GDP on account of slower growth. Other factors affecting the outturn were largely offsetting. Expenditures were driven up by extra spending on account of the 2002 summer flooding and new demands, notably a substantial increase in family benefits, rising outlays on account of subsidised part-time employment for older people, and an investment stimulus package. On the other hand, ongoing administrative reform curbed spending. This is mainly reflected in flat outlays for active personnel. Largely reflecting the impact of past decisions, the deficit is set to rise in 2003. Public sector reform, including further reform of the social security system, continues to rank high on the government's policy agenda and will be needed to move on to a sustainable path of fiscal consolidation.

The new government, which came into office in March 2003, has widened priorities to include substantial income tax reductions that are planned to be phased in from 2004 onwards. As the tax cuts are not scheduled to be balanced soon by corresponding reductions in spending, they would entail higher deficit levels for some years, before fiscal consolidation

would resume. Austria's tax-to-GDP ratio is high by international comparison, and so are tax wedges on labour. While this reinforces the case for tax reductions, policies need to take into consideration the trade off between the beneficial effects of lower taxes on the one hand and maintaining the momentum of fiscal consolidation on the other hand. With a number of risks surrounding the evolution of the general government balance in the medium term, adverse shocks might easily push the deficit to much higher levels than foreseen in Austria's Stability Programme. Moreover, future spending pressure is looming, notably on account of the rapidly ageing population. Hence, cuts in government expenditure are necessary to create room for the planned tax reductions.

### How should public sector reform progress?

Reductions in personnel play a large role in the government's fiscal consolidation policies, and have been significant over the last couple of years. But a large share of the cuts has been introduced by an early retirement package under very generous conditions. This is costly and at variance with the need to raise labour force participation. Instead, public sector employment rules should be made more flexible so as to support the reallocation of staff. This entails in particular:

- Current definitions of admissible reassignments of civil servants with respect to their function and pay should be revisited to assess whether they are broad enough.
- Abolishing special tenure for civil servants and associated rigid pay schemes should be considered.
- Full harmonisation of the pension schemes for civil servants with the general public scheme is necessary to abolish a significant hurdle to mobility between the two sectors. This would be facilitated by establishing individual pension accounts that are governed by the same standards across the different schemes.

The authorities have made progress with respect to aligning the provision of certain administrative and judicial services at the regional level. To fully reap the benefits of this reform it should be followed up within the states by concentrating related tasks in the hands of one and the same regional administration so as to further promote the implementation of the one-stop-shop principle for regional services as well as administra-

tive permissions necessary for the establishment and operation of industrial plants. This requires adjusting the allocation of funds in accordance with the redistribution of tasks. However, more fundamental reform of federal fiscal relations is necessary. The following areas deserve particular attention:

- While the intergovernmental revenue redistribution system has succeeded in achieving a high degree of income equalization across regions, it appears complex and opaque. Redistribution mechanisms were found to produce effective tax rates for marginal revenues generated at the level of the communities of close to or above 100 per cent, providing disincentives for local policies designed to enhance growth.
- Spending and financing responsibilities in several areas are mixed between the federal government and the states or between various authorities. Examples are, *inter alia*, the provision of means-tested income replacement benefits for the unemployed, the funding of teachers and the financing of waste water purification facilities and networks. This can cause significant inefficiency in resource allocation, making fiscal consolidation policies more difficult and reducing policy effectiveness in areas such as labour market or educational reform.
- Reform of the federal fiscal system should therefore strengthen the congruence between spending and revenue responsibilities. To this end, choices need to be made both in terms of what services can be better provided by the private sector rather than the government, and which level of government is best suited to deliver public sector services. Local governments could be given more scope to generate own tax revenues, and the volume of co-funding should be scaled back correspondingly to reduce the adverse incentives generated by the present system. In addition, efforts should be made to internalise spill-over effects of local services to other localities via co-operation of local governments or public institutions or by merging local utilities. ■

### Is pension reform complete?

Earlier pension reform has not secured the sustainability of Austria's pension system. In the OECD, Austria stands almost at the top with respect to the size of public pension outlays relative to GDP. These outlays were projected to continue increasing at an unsustainable pace, with adverse implications for social charges, employment and growth. The government has, therefore, undertaken an ambitious programme

aimed at significantly slowing the trend rise in pension spending. The reform measures thus far legislated mark substantial progress in securing the sustainability of general government finances. This is notably the case for the extension of the accounting period on which pension claims are based, which increases incentives for full-time labour force participation over the life cycle, and the abolition of early retirement on account of unemployment. Some important elements are still missing, however, and the following points are important to make the reform a lasting success:

- The accumulation of pension rights should be made actuarially fair so as to allow employees to determine the length of their working life taking into consideration the trade-off between shorter life-time employment and lower pensions, while ensuring that early retirement would not raise the fiscal burden for the pension system. This would be facilitated by appropriately designed individual retirement accounts. The actual and desired redistributive elements within the pension system should be clearly identified, with desired redistribution tax financed to the extent it is not yet covered by transfers out of the federal budget.
- Efforts need to be made to ensure that efficient instruments are available to support private retirement savings as a supplement to the pay-as-you-go part. The revised system of severance pay is a considerable step in this direction. Certification of retirement savings instruments needs to proceed so as to secure a high degree of competition between eligible funds. The provision that tax-preferred pension instruments can only be invested in thin markets should be dropped. ■

### Which labour market reforms can generate more employment?

Simulations by the OECD indicate that, without change in framework conditions, population ageing will substantially reduce labour force participation in Austria over the next decades. Austria's transfer system contains barriers to labour force participation, in particular for older people. These need to be ended, while other channels into effective early retirement outside the old age pension system need to be closed for pension reform to be successful. The scheme that subsidises part-time employment for older employees has been revised so as to reduce adverse implication for labour supply. However, the government should consider abolishing the scheme entirely. Further important issues are:

- Preferential conditions for older people to receive unemployment benefits should be phased out.
- Abolishing incentives for early retirement requires that eligibility conditions for invalidity pensions are strictly conditional on health reasons and are tightly controlled.
- The early empirical evidence on the new system of child benefits (*Kinderbetreuungsgeld*) suggests that on balance it might diminish female labour supply and the tax and benefit system overall can produce sizeable effective tax rates for secondary earnings. The structure of family support policies should therefore be revisited so as to reduce unwanted reductions in female labour supply. One way to improve the compatibility of work and family obligations would be to devote a larger share of total family benefits to child-care facilities so as to increase the numbers and ease of access, thereby cutting the time spent in transporting children to and from the premises. Extending the supply of full-day schooling could also help.

Real wage flexibility at the macro level has been found to be high in Austria, and this has helped the economy to avoid large fluctuations in unemployment. However, supporting the adaptability of the economy to supply shocks and the employability of certain groups of employees, such as older people, suggest that the flexibility of relative wages needs to be improved and remaining distortive features of dismissal protection for older employees revisited.

- Wages rise significantly with age for both salaried employees and civil servants. To support the firms' labour demand for older workers, policies should aim at abolishing the factors that hold seniority wages artificially high, *i.e.* out of line with productivity. Several recent policy initiatives, such as the extension of the wage base for pension claims, already go some way in providing incentives for changes in this direction. But further reform is necessary, such as revisiting remuneration schemes in the public sector. Moreover, the social partners should make further efforts to rebalance wage schedules in favour of higher employment for older people.
- The distribution of relative wages across sectors and firms appears to have rigid elements. To foster adjustment of wages in accordance with differential developments in employment conditions and productivity, the present "Distribution Options" at the firm level should be developed into opening clauses that allow deviations from collectively bargained out-

comes if a plant level agreement comes about between the management and the labour force.

- Currently, age is one of the social considerations which employers need to take into account in their dismissal decisions. This provision has contributed to the high utilisation of effective early retirement programmes and the low employment rates of older employees. While the waiting period for application of the special dismissal protection was recently extended, a more stringent revision of age-related employment protection should be considered so as to improve the incentives to keep productivity and remuneration of older workers in line with each other and thereby increase firms' incentives to employ older people. ■

### What reforms can contribute to making the education system more efficient?

To ensure skills consistent with high levels and growth of productivity improving the efficiency of schooling and encouraging life-long learning is of particular importance. In the Austrian context, the potentially beneficial role of life-long learning is reinforced by the prospect of a rapidly ageing society and the desire to increase employment opportunities for both women and older persons.

- According to the OECD's PISA study, student performance in Austria ranks in the upper middle range of OECD countries, though schools vary considerably in the quality of educational outcomes. The fact that Austria has the highest accumulated expenditure on primary and secondary schooling per student relative to GDP per capita indicates that there is considerable scope for efficiency improvements. In particular, although some progress is being made in developing quality standards for educational attainment in some areas, mandatory country-wide educational targets against which the performance of schools can be assessed on a regular basis have not been established. A commission was recently set up for the purpose of making suggestions on how to shift the system from input orientation toward focusing on learning outcomes. Reform along these lines should be implemented.
- As is apparent from the recent introduction of the general tax allowance for training, improving the skills of the workforce ranks high on the government's agenda. The system of adult learning can be improved on several scores. Programme evaluation

needs to become more common. It should become a regular tool on which the policy makers' decisions on the use of resources for the various target groups and the design of programmes can be based. Using vouchers more widely would help in this respect by strengthening the scope for a market mechanism. Different paths of training and education should be better integrated. In particular, better links should be established that provide an option for the unemployed to develop further the skills obtained in labour market programmes by participating in education programmes. While responsibility for funding and designing adult learning is dispersed across several authorities, there is often little co-ordination between them. More co-ordinated programme design is likely to raise the effectiveness of adult training and generate savings in the general government budget. ■

### How can product market regulation boost productivity growth?

The OECD growth study has provided evidence that competition-enhancing policies can foster the growth of productivity and employment. While some reforms of competition-related policies have been implemented in recent years, legal restrictions continue to impair competition in many product markets. Moreover, unduly restrictive regulations are particularly widespread in the services sector. This is manifest in comparatively weak productivity growth in this sector over the past decade, while manufacturing performed well by international comparison. In-depth analysis suggests that comprehensive reforms of the domestically oriented industries and of public procurement policies could substantially boost consumer welfare.

Last year's reform of competition law took important steps towards aligning the Austrian framework with the mainstream. In particular, the reduction of the social partners' direct influence and the creation of an independent competition authority were commendable, albeit overdue. Yet the institutional set-up now in place and procedures for enforcement are overly complex. These shortcomings should be remedied. – Most importantly, the currently inadequate capacity of the competition authority should be considerably increased. A leniency programme should be introduced and the introduction of criminal sanctions for hard-core cartels considered.

Weak performance is widespread in the services sector, owing in large part to regulations that thwart competition.

- Productivity in retail distribution in general is lower than in many comparable countries. This reflects the fact that regulations of large stores and opening hours are stricter than elsewhere. For example, up to now average shop opening hours were the shortest in the European Union. Besides limiting consumer choice, these regulations prevent taking advantage of economies of scale. The federal government has widened the legal scope for extended shop opening hours. The *Länder* should make full use of this option; and broader liberalisation of the retail sector should be considered.
- Trades and professions are subject to a complex set of regulations, comprising both statutory provisions and significant elements of self-regulation. There is evidence that this contributes to higher prices and the observed low firm turnover rates might also be related to restrictive regulations. There is considerable scope for discontinuing some existing provisions or reforming them so as to minimize their distorting effects on competition. For example, for those activities where certification is warranted in order to safeguard certain levels of quality, it should pertain to employees rather than owners. In professional services, recommended fee schedules, issued by the relevant associations, effectively prevent price competition and should be prohibited.

While Austria has been early to liberalize electricity demand, it is imperative that the structure of the industry becomes more competitive. At present, production and distribution remain characterized by extensive vertical integration and government ownership. The latter follows directly from legal regulations of ownership and restrictions of voting rights. The government is actively encouraging further consolidation, while the competition authorities did not publicly advocate competitive solutions in the recent prominent merger case. Further domestic consolidation is considered necessary by the authorities for safeguarding the international competitiveness of Austrian producers after the imminent opening of the European electricity market. This is a misguided aim if it leads to higher prices for consumers, and it would impair the competitiveness of Austrian producers in other industries. Moreover, the consolidation might permanently prevent Austrian consumers from gaining the benefits of the larger European market.

## How can the cost-effectiveness of environmental policies be improved?

Sustainability issues rank high on the government agenda in Austria and the population is ready to accept the costs associated with ambitious targets. The Austrian government has embarked on a far-reaching programme to reduce greenhouse gas emissions. Under the EU burden sharing agreement it accepted a cut in emissions of twice that of the rest of the EU. With emissions still above their 1990 level, a reduction of 20 per cent is now needed to achieve compliance. Realising such a cut in emissions is likely to be costly. While the target itself could be justified in light of the high public support for environmental issues, cost effectiveness can be improved by using more economic instruments, notably by widening the coverage of emitters subject to a tax of some sort. However, domestic abatement should only be promoted up to the point where marginal costs are equal to the price of emission permits in the EU market once it is operational, which would entail scaling back programmes where such costs are clearly excessive. If mishandled, the disposal of waste can cause long-lasting damage to ecosystems and to human health. Due to stringent governmental regulations and incentives, hierarchical waste management policies achieve very high recycling rates, in most cases mandated by EU legislation, but are associated with high costs for consumers and producers. These are in part induced by taxes aimed at minimising waste generation. Some parts of the programme may absorb more resources than are saved by recycling. More systematic use of the results of cost-benefit analysis in policy formulation would help to improve the cost-effectiveness of policies aiming at improving the sustainability of economic development. ■

## What can be done to make development aid more effective?

The volume of the Austrian aid programme increased markedly in 2001 and is now very close to the OECD median effort. Also, the government aims at raising assistance further to the level of the Barcelona target of the EU (0.33 per cent of GDP). Until recently, a considerable part of it was oriented towards other European countries. This was a strategic objective for Austria but meant that less than one-quarter of aid went to least-developed countries. However, new legislation, effective from January 2004 onwards, provides for the creation of an Austrian Development

Agency designed to enhance the efficiency of aid delivered. The lessons learned from assessing previous projects have encouraged a shift in priorities for aid to South East Europe away from physical infrastructure towards social services, mainly education and health, which now represent about half of Austria's bilateral ODA. At the same time, an effort is being made to improve the capacity for foreign trade of developing countries. Such initiatives represent a modest share of Austrian aid but the authorities intend to expand them. To achieve maximum impact,

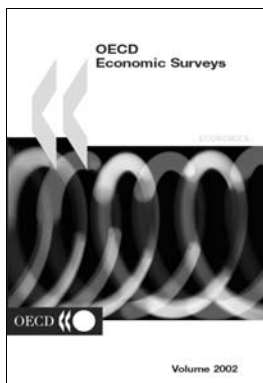
these measures require multilateral action to further open trade for products from these countries including for agriculture. ■

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