

Assessment and recommendations

A well performing economy that could do better

Economic growth in Austria since the mid-1990s has been roughly in line with the EU average. However, it appears that the economy has not yet embarked on a path of higher trend growth even though Austria's EU accession in 1995 and the market transition of eastern European countries eliminated many entry barriers for Austrian exporters and importers. While trade shares increased rapidly, Austria lost market share. Two broad issues deserve special attention with respect to raising Austria's growth potential. Firstly budgetary consolidation was delayed for too long, and a distortionary fiscal stop-and-go policy adopted. In a similar vein, significant public sector reform was delayed in the 1990s, precluding the potentially positive impact of such reform on the functioning of the economy overall. Secondly, Austria delayed reform of its regulatory framework. This is understandable, since this framework successfully supported high economic growth during earlier times of relatively modest structural change. However, reaping positive growth effects from increased international integration and more rapid technological change requires more thorough reform in product and labour markets favouring market determined outcomes and higher structural flexibility. Ongoing policy action is already proceeding along these lines, but the remaining challenges of overdue structural reform are significant. While the first chapter reviews the main macroeconomic forces at work and the Secretariat's projections, issues of fiscal policy and structural reform are highlighted in Chapters II and III of this report. Finally, Chapter IV considers in some detail issues associated with encouraging environmentally sustainable economic development.

External developments dominated the business cycle over the last two years...

Real GDP growth in 2000 totalled 3.0 per cent, well above potential, and in line with the average in the EU. The Austrian economy participated in the economic upswing within the EU that was driven by accelerating world trade in the second half of 1999 and into 2000. On the domestic side, the upswing was underpinned by strong private consumption, with disposable incomes benefiting from tax cuts that became effective in January 2000, and robust growth in investment in machinery and equipment. But the economy's momentum slowed in the second half of 2000 and into 2001 as world trade growth decelerated. Private consumption growth declined as consumer price inflation increased, mainly due to higher oil prices and the weakening of the exchange rate. Investment in machinery and equipment also grew at a slower pace from the second half of 2000 on, while construction investment was weak throughout. Employment continued to grow, but at a decelerating rate with unemployment even increasing in recent months. Consumer price inflation peaked in spring 2001, at a rate of 3¼ per cent. Higher indirect taxes added to the increase in the price level. But by mid-2001, inflation had come down substantially, as the effects of the previous oil and import price increases began petering out, and the impact of last year's indirect tax increases levelled off. While wages picked up in 2000, wage settlements remained moderate, supporting employment generation.

... slowing growth temporarily this year and next, though activity is projected to pick up from the second half of next year on

Growth in 2001 is likely to be markedly lower than the year before, dropping to a rate significantly below potential in the OECD's projections. This reflects the deceleration in world trade and slowing domestic demand that have been evident during the course of the year, and this weakness is now reinforced by the negative global growth shock emanating from the 11 September terrorist attack on the United States. Adverse confidence effects of this event are projected to weaken global activity and trade well into the first half next year. But world trade growth may begin to strengthen again thereafter, leading to a progressive pick-up in Austrian activity which will also be supported by more vigorous domestic demand. Indeed, private consumption is likely to recover as consumer confidence stabilises, driven by rising disposable incomes, rises in family benefits and

improving terms of trade. Investment in machinery and equipment should also gather momentum, following the improvement in external demand. Construction will remain subdued in 2002 but should strengthen thereafter. While government consumption is projected to slow, owing to ongoing fiscal consolidation, monetary conditions are projected to support growth. All in all, GDP growth is projected to rebound in the second half of next year and to accelerate further in 2003, allowing the output gap, that is opening in 2001 and 2002, to begin to close again. Risks to these projections consist mainly in a slower-than-expected recovery in world trade which could, in particular, postpone the projected upswing in Germany, Austria's main trading partner.

**General
government
balances
improved slowly...**

Fiscal consolidation was essentially put on hold after 1997, so that the general government deficit widened in 1998 and was roughly unchanged in 1999. In 2000 implementation of the federal budget was delayed due to the transition phase associated with establishing the new government after the general elections; and tax cuts and phased increases in family benefits that became effective in January 2000 further complicated the task of returning to a consolidation track. Nevertheless, in 2000 the general government deficit was reduced by 1 percentage point of GDP, to 1.1 per cent, mainly as the result of higher annual growth, one-off receipts from the auctioning of UMTS mobile phone licenses – totalling 0.4 per cent of GDP – as well as revenue-raising measures installed by the new administration.

**... with plans
to consolidate
further this year
and next**

The government aimed in the 2000 Stability Programme to reduce the general government deficit to $\frac{3}{4}$ per cent of GDP in 2001, balance the budget by 2002, and maintain balance thereafter. To this end a consolidation programme has been put forward consisting of both expenditure restraint and revenue raising measures. On the expenditure side, savings are to be generated largely by structural reform measures, notably pension reform, reductions in government employment on the federal and the local level, more focused targeting in the provision of social transfers, and measures designed to slim down the public administration and transferring tasks to the public enterprise sector. Some

initiatives along these lines have already been implemented while others still need to be decided. On the revenue side, some measures to broaden the tax base have been taken, but a significant part of the consolidation in 2001 consists of one-off measures. Higher than expected business tax instalments and lower interest payments in late 2001 imply that a balanced budget is likely to be reached already this year. On the other hand, the sharp deceleration in economic activity has made it considerably more difficult to maintain balance in 2002. The Secretariat projects for 2002, assuming both the implementation of the budgeted consolidation measures and scheduled increases in child benefits, a deficit of almost ½ per cent of GDP, reflecting essentially the budgetary effect of the automatic stabilisers.

Structural reform and strict spending control are needed to make the fiscal turn-around sustainable

Earlier episodes of fiscal consolidation in Austria in the last decade were succeeded by rapidly rising structural deficits. This reflects both the fact that past consolidation policies relied to a large extent on one-off measures and also that, with fiscal balances improving, new social entitlement programmes were instituted. In the present phase, balancing the budget over a couple of years appears feasible even though growth has slowed. However, several risks, both on the revenue and on the spending side, require tight spending control for the medium-term consolidation targets to be met. Most importantly, one-off measures play a significant role in the government's savings programme, and not all parts of envisaged structural reform have yet been decided or implemented. Moreover, new spending programmes are envisaged, with the new family benefits that will come into effect in January 2002 placing a heavy burden on the general government budget, accounting for some ⅓ per cent of GDP. Hence, a sustainable elimination of the general government deficit requires rapid replacement of the one-off measures by structural policies that are associated with lasting savings. The government should identify spending programmes where cuts can be made. Over the next years tax reductions should be implemented, but have to be backed up by structural reductions in government spending. Otherwise, there is a risk of a renewed spending cycle that would endanger the achievements made. Moreover, creating a budgetary surplus would help cope with fiscal pressures associated with ageing.

Public sector reform should be deeply rooted and implemented quickly...

Reforming various aspects of the public sector ranks high on the government's policy agenda. Indeed, public sector reform is important both for fiscal consolidation and for increasing the sector's efficiency and widening the scope of market-determined outcomes. While some elements of the reform have been decided, notably the reduction of public sector employment and the streamlining of some parts of public sector administration, important elements are outstanding. Taking tasks out of the government sector and incorporating them in the public enterprise sector, as scheduled, can increase public sector efficiency under certain conditions. However, the evidence from previous action yields a mixed picture, and there is even the risk that spinning off companies from the budget might reduce fiscal discipline. Thus, such action can be no substitute for fundamental reform. Effective duplication within public sector administrations should be identified and abolished. Moreover, choices need to be made as to what services should be left to the private sector for provision; action in this field can be based on proposals that have already been made by a reform commission – the *Aufgabenreformkommission*. Analysis of the costs and benefits of policies needs to be developed, and for this purpose a coherent framework for *ex ante* and *ex post* project evaluation needs to be established. Efficient project selection requires estimating the likely future revenues and expenditures over a horizon of several decades and assessing their present value.

... and the congruence of spending and revenue raising powers at the various levels of government should be improved

Issues of public sector efficiency also arise with respect to the allocation of tasks and revenue raising powers across the different levels of government. The process of negotiating revenue sharing is non-transparent and the system provides few incentives at sub-central levels of government for efficient use of resources and for evaluating the efficiency of spending plans. Instead, general tax receipts should be distributed across government levels in accordance with fixed principles, and the revenue raising powers of the *Länder* and communities should be exercised and extended if necessary. In the same vein, ongoing policy initiatives aiming to improve the assignment of tasks by government level should focus on increasing the congruence between spending and financing responsibilities.

Fundamental pension reform is necessary

Important steps were taken in 2000 to limit the fiscal impact of ageing on the public pay-as-you-go system, in particular by making early retirement less attractive. Pre-empting the rapid rise of pension claims over the next years and decades requires further reform however, which should be implemented soon. Increasing retirement ages appears particularly important, and further reform in this field would have to consider all potential channels into early retirement, including invalidity pensions. Also, the fragmentation of the pension system into different occupational branches, each serving its own clientele, should be abolished. To strengthen the link between pension contributions and pensions received, entitlements should be related to the retirees' earnings base during their entire work history rather than the best 15 years. The redistributive role of the system should be identified and redistribution should be financed out of general taxes instead of wage-based contributions. Benefits provided by the pay-as-you-go part of the system should be adjusted so as to secure the system's fiscal sustainability, and a supplementary funded layer should be developed. This could be achieved by transforming the system of severance pay into compulsory company-based funded pensions. Already existing private pension investment funds have hardly been accepted yet by households, despite preferential tax treatment. The evolution of such funds should therefore be monitored, and the regulatory framework reconsidered if necessary.

Measures have been taken to reduce non-wage labour costs and raise incentives for job search, leaving scope for further improvement

The Austrian labour market continues to exhibit a comparatively low level of unemployment and a high degree of aggregate wage flexibility. The relatively moderate wage increases and steady employment growth seen in 2000, at a time of significant oil and import price hikes, validate this finding. But labour utilisation of females and older workers is low, and there is a mismatch developing between qualifications demanded and supplied. With respect to labour market reform, the new government is emphasising the need to increase incentives in the labour market and the effectiveness of job placement, and significant policy initiatives along these lines have either been implemented or are in preparation. Some eligibility rules for receiving unemployment benefits have been tightened and this should

strengthen the incentives for job search. Measures to reduce non-wage labour costs and improve the targeting of social transfers have also been taken. Scope for further action remains, however, and not all measures taken appear to be consistent with raising incentives for labour force participation and employment creation. Indeed, this is likely to be true for subsidies extended for working time reductions of older employees (*Altersteilzeit*), which need to be reconsidered. Also, the extension of child benefits scheduled for 2002 is likely on balance to reduce working hours supplied by parents, particularly women. In the unemployment insurance, the lengthening of the period of unemployment benefit receipt is likely to adversely affect job search and should be revised. Plans to widen the definition of “acceptable jobs” with respect to the skill profiles for recipients of unemployment related benefits should be implemented, and the acceptability criteria should be progressively broadened with unemployment duration.

***Better job
placement would
improve labour
market outcomes***

A key aspect of the envisaged reform of the Public Employment Service (PES) is achieving a better integration of the PES activities concerning counselling, job placement, provision of active labour market measures and provision of unemployment benefits. Indeed, the efficiency of the job matching process has been found elsewhere to increase with the interaction between the different functions in the placement process, and initiatives to better integrate these functions are therefore welcome. Similarly, better integrating the unemployment assistance and social assistance systems, for which responsibilities are dispersed between the federal and the regional authorities, needs to be considered. Moreover, the scope for private placement agencies within an integrated employment service should be widened. Active labour market policies (ALMPs) play an important role in the government’s employment strategy. Within a framework of improving the “profiling” of the unemployed with respect to relevant economic characteristics, ALMPs should be better utilised to test the readiness of benefit recipients to take up work. Moreover, to secure the effectiveness of training and work provision schemes, measures should be tightly targeted on problem groups. In general, there is a risk that private sector entrepreneurial activity is

crowded out by public work programmes, and associated deadweight costs are often substantial. Appropriate evaluation of the effectiveness of the measures utilised with respect to increasing employment chances and minimising dead weight cost and crowding out effects is therefore imperative and should be stepped up. Putting more emphasis on in-work benefits that ease marginal effective taxation associated with the transition into regular employment can be a promising strategy for “activating” unemployment-related benefits and social assistance schemes.

Reform of the education system is being addressed and should rank high on the policy agenda

The increasing importance of skilled human capital in a “knowledge-based society” reinforces the need for reforming Austria’s education system. Tertiary education in Austria has been found costly and its allocational efficiency needs to be improved to cope with a widening gap in skills provided and demanded. The government has embarked on a reform programme aiming at raising the quality of tertiary education and the efficiency of university funding. Major elements of the programme are the abolition of lifelong tenure for university teachers, the introduction of performance-related elements both into the remuneration system for teachers and the funding of the universities more generally, and a higher degree of university autonomy in designing their areas of research and education. From autumn 2001 onwards, students will be charged tuition fees, the proceeds of which will be redistributed to the universities. The plans for university reform go in the right direction and should be carried through. In particular, while the introduction of tuition fees is welcome, raising the financial endowment of the universities is not sufficient for improving performance. Rather, reform should quickly move on to establishing a higher degree of competition between universities and a link between the universities’ performance and their funding. Austria’s dual apprenticeship system has been successful hitherto in providing applied skills, thereby contributing to holding down youth unemployment to comparatively low levels. Efforts have been made over the past years to adapt apprenticeship curricula to new demands. This policy needs to continue. Markets should be allowed to adjust pay scales so as to balance demands and supply for training across occupations.

Forthcoming competition legislation should strengthen enforceability

The current regulatory system for general competition issues – particularly mergers and cartels – is based on a cartel court that has limited legal powers to instigate actions independently, but acts on the recommendations of the social partners, with the Minister of Economic Affairs and Labour representing the state before the court. The government has tabled legislation to establish an independent competition authority, and this would mark important progress towards a system of effective competition enforcement. To secure effectiveness the institutional design needs to be streamlined. Firms violating the law should be subject to fines set sufficiently high to deter anti-competitive activity (particularly cartels). Adopting a leniency programme should be considered whereby the first firm to divulge the existence of a cartel and to co-operate fully in its prosecution would be eligible for reduced sanctions. Also, it needs to be established whether personnel are sufficient to secure effective investigation, with staffing being increased quickly if necessary.

Regulatory reform of network industries is progressing, but open issues remain

There have been some positive developments in network industries, and significant steps have been made to open some markets to competition. Prevailing market structures suggest however, that a lot remains to be done to firmly establish competition in network industries. As in almost all OECD countries, regulatory reform in telecommunication led to sizeable price cuts and a widening range of services. Partial market opening has also induced price cuts for electricity. In the electricity and the gas sectors the government has scheduled full market opening for fall 2001 and 2002, respectively, well ahead of the requirements stipulated in the respective EU directives, but this needs to be backed up by further reform. Regulatory reform in the postal sector, on the other hand, is not particularly advanced, and little progress has been made with respect to introducing competition in the railways system. Policy action in these fields could be expected to generate potentially very substantial welfare improvements for consumers and to contribute to increasing productivity growth in the economy. Major open issues are:

- In *telecommunication* the regulatory framework should be extended so as to allow pro-active measures, that follow rapidly changing market structures, of the telecommunication regulator on

- its own initiative. To increase competitive pressures in the mobile phone market number portability should be imposed.
- With vertically-integrated utilities dominating *electricity and gas markets*, effective non-discriminatory access to networks is not fully secured. Thus, to strengthen competition, grids need to be completely unbundled from distribution and generation. At the minimum, this requires a separation of networks and generators into different legal entities. This should be reinforced by privatising utilities.
 - In the *postal sector* the Austrian Post has exclusive rights for delivery of letters weighing up to 350 grams. This monopoly right should be reduced and preferably terminated. The regulatory competence should be transferred from the Ministry of Transport, Innovation and Technology to a strong independent regulator.
 - In the *railway sector* entry of private providers of transportation services should be fostered. This requires, in particular, that independence be established of the grid from the provider of transport services.

Important regulatory issues also arise with respect to non-network sectors. The regulation of shop opening hours should be liberalised further. Public procurement rules should be made uniform across the different layers of government, based on open tendering. Privatisation should be extended to the remaining state-owned banks at all levels of government.

Environmental standards are high in Austria, but the policy framework needs to be improved

Environmental standards are high in Austria, and this is reflected in elaborate environmental regulations, the incorporation of environmental concerns in the planning of major infrastructure projects and Austria's ambitious international commitments. Environmental objectives are backed by a very broad political consensus, and substantial financial resources are devoted to meeting environmental goals. However, a well-established framework for integrating environmental concerns into general policy planning is lacking. In particular, there is little *ex ante* and *ex post* evaluation of

implied economic costs and potential environmental benefits. Not least, this implies that policies directed at similar objectives are not well balanced so as to secure high degrees of overall efficiency. A consistent framework for cost-benefit analysis across policies should therefore be introduced.

An ambitious Kyoto target serves as the flagship of Austria's climate change policy

A prime example for Austria's ambitious environmental goals are large reductions of greenhouse gas emissions. However, the policy mix applied for this purpose can be improved. While much emphasis is put on "command-and-control" type regulations, economic instruments are not closely linked to environmental goals: taxes on energy provide little incentives for more environmentally-friendly economic behaviour and certain subsidies are given without sufficient evaluation. In particular, effectiveness of current regulation concerning the efficiency of motors and heating plants could be enhanced by the introduction of a CO₂ tax or trading scheme. Thereby emission reduction would become a matter of economic self-interest, reducing the need for costly technical controls. The CO₂ tax would allow to better focus the structure of energy taxes on the abatement of greenhouse gas emissions. Exemptions that are not environmentally motivated – such as preferential taxation of diesel – should be abolished. A CO₂ tax could also reduce the need for environmentally motivated subsidy programmes aiming at supporting renewable energy sources, thermal insulation of the existing housing stock, central heating plants and public transport. Social concerns could be addressed via means-tested social transfers. Moreover, concerns about negative impacts on Austria's international competitiveness could be dealt with via a grandfathering scheme that maintains incentives for new investment.

Road pricing that generates incentives to avoid environmentally damaging traffic should replace the eco-point system

NO_x emissions associated with transit traffic of trucks were successfully reduced via an eco-point system, negotiated along with Austria's EU-accession, in which NO_x-related points are allocated to trucks. It is unlikely, however that the transit agreement can be indefinitely extended. Moreover, the present system provides insufficient incentives to utilise clean transport technologies in trucks. Thus, the regulation of transit traffic needs to rely on increasing the marginal cost of environmentally damaging transit to replace the

present “eco-point” system, and this suggests introducing a road pricing system that takes into account the environmental costs of transportation through sensitive regions. The pertinent EU legislation should be adjusted accordingly in the light of the recently published EU White Paper.

Introducing full cost recovery pricing while phasing out capital cost subsidies could secure water service infrastructure investments for the future

Water issues are considered with high priority by the Austrian public, hence the Austrian government aims at making sure that sufficient investments in water service infrastructure are made in order to maintain the high quality of water. Improved efficiency in achieving this objective could be promoted by phasing down capital cost subsidies for water treatment while moving in parallel towards full cost recovery pricing principles, thus revealing particularly inefficient water service providers, increasing the efficiency of the water service infrastructure and improving resource allocation. This would fully support the envisaged and the already implemented measures as stipulated in the Austrian government programme. Also, waste collection and treatment charges should be set as to reflect the costs of emissions into air and soil. Such a system could improve efficiency in the disposal of waste.

Environmental services from agriculture should be exposed to cost-benefit analysis

In agriculture many efforts were made to promote more environmentally friendly practices. However, resource allocation could be improved if the support system were changed from being production method oriented to be targeted at specific environmental outcomes via cost-benefit analysis. This would be enhanced by cost sharing with tourism, to the extent tourism benefits from the landscape preservation due to farming. The current excess supply of certain organically farmed output suggests that more room should be provided for market determined outcomes while administrative measures should focus on framework conditions.

Summing up

Economic growth in Austria is currently weakening and will be adversely affected by the global shock emanating from the 11 September terrorist attacks in the United States. However, growth is projected to recover from the second half of next year on, reflecting an expected improvement in world trade and monetary conditions that will not act as a

brake on GDP growth. However, important challenges remain if Austria is to raise its growth potential and fully benefit from European integration. Wide-ranging structural reforms announced by the government include putting the pension system on a fiscally sustainable base, increasing the efficiency of the public sector, tightening the targeting of social benefits, improving incentives in the labour market, opening network industries to competition, and lifting the performance of the education system. Most of these initiatives go in the right direction, and would accelerate the pace of structural reform if they were fully implemented. Several policy measures along these lines are already in force or being introduced. In some cases, however, policies appear to be at variance with improving economic incentives or fostering fiscal consolidation. It is particularly unfortunate in this respect that the government is introducing a major extension of an already generous child cash support system which is likely to exert a negative impact on working hours supplied by parents. More fundamental pension reform is necessary, the efficiency of job placement needs to be improved and plans for university reform should be carried out. While good progress has been made with respect to competition legislation, market opening needs to be backed up by further reform. A sustainable elimination of the general government deficit requires rapid replacement of budgeted one-off measures by structural policies that are associated with lasting savings. For this purpose spending programmes should be identified that can be cut. More efficient project selection also requires establishing an effective framework of *ex ante* and *ex post* policy cost evaluation. Effective duplication within public-sector administrations should be identified and abolished, and choices need to be made as to what services should be left to the private sector for provision. While eliminating the general government deficit should remain the primary short-term consolidation target, creating a general government surplus in the medium-term would help cope with fiscal pressure associated with population ageing. As regards environmentally-sustainable growth, Austria is acting from a position of relatively good environmental performance and with the ambition to further improve environmental outcomes. However, the policy mix being used relies too much on command-

and-control type measures, while economic instruments – both in the form of subsidies and taxes – are not linked tightly enough to environmental goals, resulting in higher costs and distortions. Thus, more use should be made of economic instruments to improve environmental performance notably, by introducing a CO₂ tax. Moreover, an integrated approach is needed that systematically utilises cost-benefit analysis and *ex post* programme evaluations to formulate environmental policies and reduce the economic burden of reaching environmental targets. Progress on all these scores is essential to facilitate the necessary institutional changes allowing Austria to further improve living standards, support social cohesion and maintain an attractive environment.