

**IMMEDIATE
ATTENTION**

SM/01/157
Correction 1

CONTAINS CONFIDENTIAL
INFORMATION

June 8, 2001

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Austria—Staff Report for the 2001 Article IV Consultation**

The following corrections have been made in SM/01/157 (5/30/01):

Page 1, para. 4, lines 2-4: for “Including the extreme-right...sanctions were lifted”
read: “In reaction to the inclusion...which were lifted”

Page 4, para. 2, line 7: for “by a cut in income tax rates”
read “by the effects of the 1999 tax reform”

Page 9, Box 1, first bullet point: new fourth sub-bullet added to read “Measures to broaden
the wage tax base. Expected yield: 0.2 percent of GDP.”

Page 13, Box 2., para. 2, lines 5 and 6: “To contribute to...0.1 percent of GDP).” deleted

lines 9 and 10: for “In an attempt...considering the option”
read “In accordance with...has the option”

Page 20, para. 23, penultimate line: for “January 2, 2002,” read “April 2, 2002”

Corrected pages are attached.

Att: (5)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

AUSTRIA

Staff Report for the 2001 Article IV Consultation

Prepared by the Staff Representatives for the 2001 Consultation with Austria

Approved by C. M. Watson and G. Russell Kincaid

May 29, 2001

The 2001 Article IV consultation discussions were held in Vienna during March 23–April 3, 2001. The mission comprised Messrs. Flickenschild (Head), Eskesen, Vocke, and Ms. Krajnyák (all EU1). Mr. Prader, Alternate Executive Director for Austria, attended the meetings. The mission met with the Ministers of Finance and Economic Affairs and Labor; the Governor of the Austrian National Bank (OeNB); other officials of the federal administration and the OeNB; the chairmen of the federal debt commission and the parliamentary budget committee; the leader of the federation of trade unions; and representatives from the lower levels of government, the chamber of industry, the banking sector, the academic community, and the main economic research institutes.

Austria has accepted the obligations of Article VIII and maintains an exchange system that is free of restrictions on payments and transfers for international transactions (Appendix II). Austria publishes comprehensive economic statistics that are generally adequate for surveillance, although the timeliness and quality could be improved in some areas (Appendix III). Austria subscribes to the SDDS, but has availed itself of flexibility options with respect to the timeliness for foreign trade and industrial production data.

At the conclusion of the last Article IV consultation on August 3, 2000, Executive Directors commended Austria's good inflation, growth, and labor market performance, and welcomed the authorities' plans to accelerate and strengthen their fiscal consolidation effort. They also encouraged the authorities to increase the flexibility of goods and labor markets and welcomed their intention to sell government holdings in commercial enterprises.

A center-right coalition government took office in February 2000, ending half a century of center-left consensus politics. In reaction to the inclusion of the Freedom Party (FPÖ) in the government, Austria's EU partners imposed bilateral political sanctions against Austria, which were lifted in September 2000.

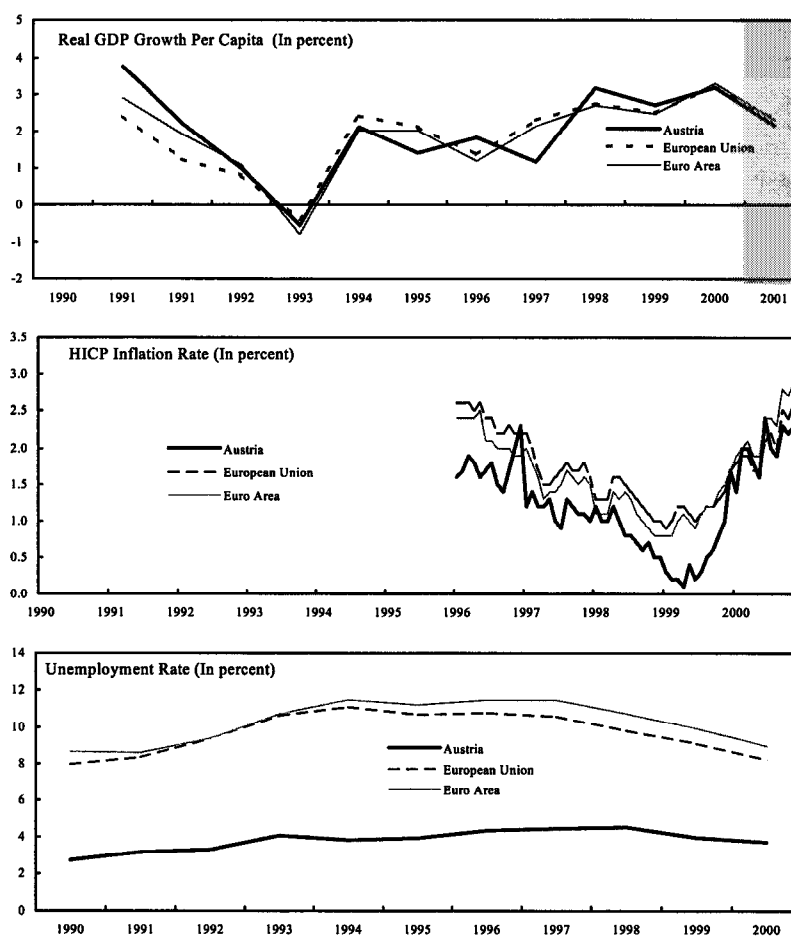
The authorities released the mission's preliminary conclusions to the public and have again agreed to publish this staff report. In light of the reasonably favorable economic outlook and the absence of acute economic problems facing Austria, this staff report is circulated to the Executive Board on a lapse-of-time basis.

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I. ECONOMIC BACKGROUND

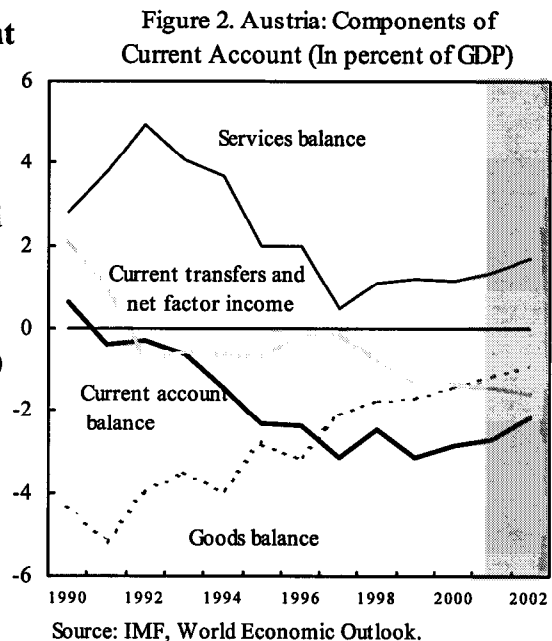
1. The Austrian economy performed solidly in the 1990s despite slow fiscal adjustment and lagging structural reforms. Per capita economic growth averaged 1.8 per cent per annum, and the unemployment and inflation rates were among the lowest in the EU (Figure 1). Economic activity benefited from Austrian firms' early involvement in the restructuring of the neighboring central and east European countries (CEECs). Further benefits can be expected from increasing integration as the CEECs prepare for EU membership. In the labor market, a long-standing social partnership helped ensure wage moderation and contain unemployment while keeping labor relations peaceful.

Figure 1. Output, Inflation, and Unemployment in Austria and European Union

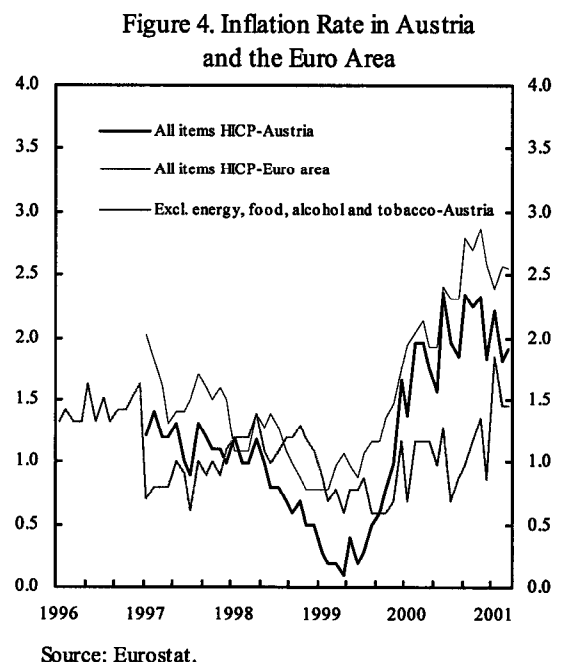
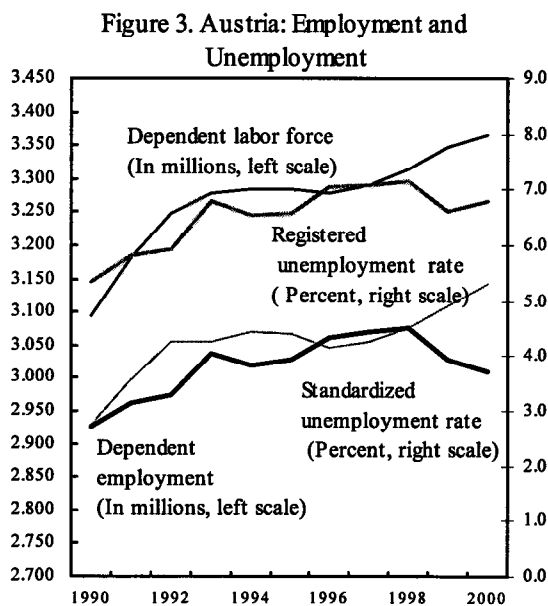


Source: IMF, World Economic Outlook; and Eurostat.

2. **Real GDP growth picked up to 3.2 percent in 2000.** After a brief slowdown in the aftermath of the Asian crisis, brisk activity resumed in mid-1999 with a rebound of exports and investment. The upswing became more broadly based when consumption picked up later in 1999, and—boosted by the effects of the 1999 tax reform—strengthened further in early 2000. Helped by a favorable external environment, growth accelerated to 3½–4 percent in the first half of 2000 before weakening in tandem with external demand. Despite higher oil prices, the current account deficit narrowed slightly, from 3.2 percent of GDP in 1999 to 2.9 percent in 2000, reflecting strong export growth and lower transfers to the EU (Figure 2).



3. **Unemployment declined to 3.7 percent in March 2001, and inflation continues to remain slightly below the euro area average** (Figures 3 and 4). Benefiting from the strength of domestic demand, employment rose by 1 percent in 2000, mostly in the service sector. Although certain segments of the labor market appear tight (e.g., in the information technology sector), recent wage agreements do not indicate a significant increase in wage pressures. The sharp increase in oil prices pushed harmonized annual inflation to 2 percent (12-month inflation peaked at 2.3 percent in November 2000 and stood at 2 percent in March 2001), but annual underlying inflation remained at around 1 percent, benefiting from wage moderation and stronger competition in newly liberalized sectors (electricity and telecom).



Box 1: The 2001-04 Stability Program

Faced with strong criticism from the EU and international institutions over the unambitious March 2000 update of their Stability Program, the authorities prepared a revised Stability Program that places greater emphasis on fiscal consolidation and targets reaching general government balance by 2002 and maintaining it thereafter, a cumulative structural adjustment of about 1½ percent of GDP. This new deficit target has been welcomed by ECOFIN.

The 2001 federal budget represents the first step in the fiscal adjustment program and targets a federal government deficit of 1.4 percent of GDP. Savings measures by the lower levels of government would help bring the general government deficit to about ¾ percent of GDP. On balance, the Stability Program's measures (Box 1 Table) at the federal level compensate for disappearing extraordinary revenues, and the federal government budget deficit remains unchanged from 2000.

- Tax measures amount to about 1 percent of GDP and enlarge the tax base by closing loopholes and eliminating preferential treatments. The most important measures are:
 - Abolition of a special tax depreciation allowance, which allowed enterprises to write off more than 100 percent of the acquisition cost of investments in productive assets. Expected yield: 0.2 percent of GDP.
 - Stricter corporate tax rules as regards, inter alia, loss carry-forwards, reserves, capitalization of late payments, and depreciation rules for buildings. Expected yield: 0.5 percent of GDP.
 - Increased taxation of trust funds (increase in taxation of initial deposits from 2.5 percent to 5 percent; capital income taxed at 12.5 percent instead of 0 percent; and taxation of withdrawals decreased from 25 percent to 12.5 percent). Expected yield: less than 0.1 percent of GDP.
 - Measures to broaden the wage tax base. Expected yield: 0.2 percent of GDP.
- Higher discretionary expenditures (inter alia, spending on R&D, restitution payments for slave labor and confiscated property of Holocaust victims, and transfers to the railways) exceed by about 0.6 percent of GDP savings on pensions (from the higher early retirement age), public sector wages (from reducing the number of civil servants via attrition), and better targeted social expenditures.

To balance the general government budget by 2002, a further ¾ percent of GDP adjustment is necessary. The 2002 budget (passed on April 4, 2001) envisages shrinking the federal government deficit to ¾ percent of GDP via lower expenditures (largely stemming from a reversal of the 2001 increase in discretionary expenditures). General government balance would be achieved by an unchanged surplus of ¾ percent of GDP at the lower government levels.

For 2003-04, maintaining the general government balance is foreseen. A planned reduction of nonwage labor costs (amounting to about ¼ percent of GDP) in 2003 is programmed to be financed by offsetting reductions in discretionary expenditures and by savings on pensions and public sector wages. Lower interest payments are expected to contribute 0.1 percent of GDP each year.

Box 1 Table. Austria: Measures of the 2001-2004 Stability Program

(In billions of schillings)

	Cumulative effect of measures of the 2001-2004 Stability Program 1/					Impact of measures				
	Of which:					Of which:				
	Cumulative effect of new measures 2/					Impact of new measures				
	2001	2002	2003	2001	2002	2003	2001	2002	2003	2003
Expenditure										
<i>in percent of GDP</i>										
of which:										
Administration	-3.6	-23.7	-38.5	9.4	-7.8	-17.0	-3.6	-20.1	-14.8	-9.2
Pensions	-0.1	-0.8	-1.2	0.3	-0.3	-0.5	-0.1	-0.7	-0.5	-0.3
Other social transfers	-5.0	-11.1	-15.0	0.2	-2.6	-4.9	-5.0	-6.1	-3.9	-2.3
Disability	-4.5	-10.9	-18.5	0.5	-0.9	-3.5	-4.5	-6.4	-7.6	-2.6
Universities	-3.7	-3.7	-3.7	-0.7	-0.7	-0.7	-3.7	0.0	0.0	0.0
Family assistance	1.0	1.0	1.0	n/a	n/a	n/a	1.0	1.0	1.0	n/a
Interest	0.5	1.0	1.0	n/a	n/a	n/a	0.5	1.0	1.0	n/a
Discretionary expenditure, misc.	0.0	7.3	9.0	-0.6	1.3	2.0	0.0	7.3	1.7	0.7
Total federal government	0.0	-3.0	-4.0	n/a	n/a	n/a	0.0	-3.0	-4.0	n/a
<i>in percent of GDP</i>										
Lower levels	19.1	10.2	6.2	18.0	6.6	1.6	19.1	-8.9	-4.0	-5.0
Social insurance	7.4	-9.2	-24.0	17.4	3.7	-5.5	7.4	-16.6	-14.8	-9.2
<i>in percent of GDP</i>										
Lower levels	0.3	-0.3	-0.8	0.6	0.1	-0.2	0.3	-0.5	-0.5	-0.3
Social insurance	-8.0	-11.5	-11.5	-8.0	-11.5	-11.5	-8.0	-3.5	0.0	0.0
<i>in percent of GDP</i>										
Revenue										
<i>in percent of GDP</i>										
of which:										
Beverage tax	26.8	26.3	19.6	19.5	23.2	16.3	26.8	-0.5	-6.7	-6.9
Non-wage labor costs	0.9	0.9	0.6	0.7	0.8	0.5	0.9	0.0	-0.2	-0.2
New tax measures	-3.0	-3.0	-3.0	n/a	n/a	n/a	-3.0	0.0	0.0	n/a
<i>in percent of GDP</i>										
Balance (revenue-expenditure)	30.4	50.0	58.1	10.1	31.0	33.3	30.4	19.6	8.1	2.3
<i>in percent of GDP</i>										
Memorandum item:										
GDP	2,924.2	3,050.9	3,185.9	2,924.2	3,050.9	3,185.9	2,924.2	3,050.9	3,185.9	3,185.9

Source: Ministry of Finance, the Austrian Stability Programme.

1/ Compared with the 2000 statutory baseline.

2/ Based on comparing the March 2000 updated Stability Program and the December 2000 revised Stability Program. The effects of individual revenue/expenditure measures do not sum up to the total due to incomplete information on the specific items and differences in the reference values.

Box 2: Coordination of Public Finances

The legal basis for coordinating public finances between the three levels of government in Austria (federal, provincial, and municipal) is provided by the revenue-sharing agreement law (*Finanzausgleichsgesetz* (FAG)). A formal coordination is necessary since most revenues stem from taxes levied by the federal government, but a large part of public expenditure is made at the lower levels of government.

General agreement on a new FAG that covers the period 2001-04 was reached in October 2000. Federal revenues are distributed among the provinces (*Länder*) and municipalities based on the size of their population, with an adjustment in favor of some *Länder* in the eastern and southern parts of Austria (with per capita income below the national average) and smaller municipalities. While the new FAG is already in effect, it has not yet been signed by the *Länder*, since the supplementary agreement specifying the lower levels' contribution to the fiscal consolidation and penalties for nonobservance is still under negotiation. In accordance with the new FAG, the Ministry of Finance has the option to withhold 0.8 percent of GDP in shared revenue if the agreement is not signed by end-2001. Penalties under the agreement would amount to a yet to be determined percentage of the fiscal underperformance.

The authorities' 2001-04 Stabilization Program relies on surpluses of at least $\frac{3}{4}$ percent of GDP by the lower levels of government to reach and maintain the fiscal objective of a balanced general government budget. The *Länder* are expected to present an aggregate surplus of $\frac{3}{4}$ percent of GDP, while municipalities are assumed to have balanced budgets over the entire period. The fiscal consolidation effort expected by the *Länder* is significant, as it represents 10 percent of their aggregate spending. While expenditure reclassification (most of which has not yet been approved by Eurostat) will account for most of the deficit reduction, fiscal adjustment will include the elimination of earmarking federal transfers for housing subsidies, cuts in administrative costs and teachers' salaries, and a reduction in investment spending.

Agreement on some aspects of the application of sanctions under the new FAG is still pending. The remaining questions include: (1) who has the power to decide on the application of penalties (the federal government or an independent council); (2) whether and to what extent shortfalls in one year can be made up by subsequent overperformance without incurring penalties; (3) whether the sanctions should be applied only with a lag of one year following non-compliance; and (4) whether the penalties should amount to 100 percent of fiscal underperformance or less.

14. **The mission raised concerns regarding the sustainability of the fiscal adjustment.** Reliance on compressing expenditure within existing structures entailed the risk of creating spending pressures in subsequent years; for instance, delayed investment projects or lagging public sector wages could lead to catch-up demands. In addition, while the 2001-02 budgets appeared to have been drawn up conservatively, uncertainties existed as to the overall cost of the planned further enhancement of family benefits (*Kindergeld*).⁵ On the revenue side, calls for decreasing taxes were already intensifying (see below). Thus, risks could emerge of a return to the “stop-go” pattern of fiscal policy. The envisaged fiscal consolidation by the lower levels of government was also fraught with uncertainties, as their contribution to deficit reduction relied to a large extent on expenditure reclassification (which could be disallowed by Eurostat) and negotiations on the planned sanction mechanism had not yet been concluded. Finally, the Stability Program’s target of year-to-year balance after 2002 would require adopting procyclical measures.

C. Medium- and Long-Term Fiscal Issues

15. **The authorities plan to reduce the revenue burden in 2003, although the extent of the relief is yet to be determined.** Priority was attached to reducing non-wage labor costs and corporate taxes (from 34 to 31 percent), the latter in response to the recent German tax reform. Cuts in income and wage taxes were considered less crucial. While the Stability Program had already included a ¼ percent of GDP reduction in non-wage labor costs (programmed to be offset by lower expenditure on pensions and public sector wages), it did not provision for further tax cuts. The mission welcomed the intended tax relief and the authorities’ focus on reducing non-wage labor costs, but cautioned that in order to avoid backtracking on the fiscal adjustment effort and preserve overall fiscal balance, revenue cuts should not exceed the margin provided by expenditure restraint. The authorities replied that they would proceed with care in identifying the scope for affordable tax relief.

16. **The authorities realized that further reforms of the public finances were needed beyond their current plans to make room for a bolder reduction in the tax burden and ensure a healthy fiscal position over the longer run.** The planned 2001–02 adjustment largely exhausts the possibilities for expenditure restraint within existing structures but still leaves the size of government at over one half of GDP, nearly 5 percentage points above the EU average. The authorities intend to continue rationalization in the public sector. Their plans include further expenditure cuts at the federal level, eliminating overlaps across ministries and between federal, regional, and local government activities, and streamlining operations in the tax and customs administrations. The mission noted that additional savings could be achieved by adopting the recommendations of the administrative reform commission (including the closure of certain government offices and agencies, the transfer of

⁵ Family benefits in Austria—most of it non-means-tested cash benefits—are one of the most generous in the EU (amounting to 2.8 percent of GDP in 1998). Planned changes include extending entitlement to, and duration of, parental allowances.

flexible seven-year transition period for the free movement of labor would help assuage widespread fears of mass migration and commuting as well as smooth smaller absorption problems. In the event, the European Commission's proposal has been formulated along similar lines. As an EU proposal temporarily restricting the flow of services involving the movement of labor was not expected, Austria had to rely on structural reforms to strengthen the competitiveness of the service activities likely to be affected.

E. Financial Sector Issues

22. **The authorities considered the Austrian banking system fundamentally sound, partly as a result of the successful implementation of internationalization strategies in the sector.** Banks appeared sufficiently capitalized (Table 4) and their risk management strategies were considered adequate. Although trends toward cost cutting and consolidation among the smaller banks due to competitive pressures continued, profitability was satisfactory, with the return on equity as high as 30 percent for some banks' activities in CEEC markets. The challenges from changing consumer savings behavior and globalization had not given rise to major problems: banks made up for the decline in their deposit base by medium- and long-term bond issues, and the internationalization of the banking sector had strengthened further with the merger of Bank Austria (the largest Austrian bank) and the German HypoVereinsbank and the continued expansion of Austrian banks to CEEC markets. In the authorities' assessment, no particular vulnerabilities were visible: the share of nonperforming loans was low and the growth in foreign currency lending to private nonbanks had slowed.¹³ Although the authorities acknowledged the risks from the Austrian banks' increasing involvement in CEEC markets, they considered the banks' eastward expansion strategy—which exploited knowledge of the local markets and concentrated on the upper segments of the corporate and consumer credit market—sufficiently prudent. To improve the supervision of foreign subsidiaries, memoranda of understanding were being negotiated with CEEC supervisors to facilitate the exchange of information and allow on-site inspections by Austrian supervisors.¹⁴ The authorities thought that after a new supervisory framework had been put into place (see below), participation in an FSAP could be useful to identify any stress points and vulnerabilities in the financial sector.

¹³ Nonperforming loans (NLPs) amounted to 3 percent of total loans at end-1999 and provisions for these loans were equivalent to about 5 percent of GDP (78½ percent of NPLs). The share of foreign currency loans (mostly denominated in Swiss francs and yen) in total loans extended to private households and companies increased from 15.7 percent in December 1999 to 17.5 percent in February 2001. This rise was attributed mainly to valuation effects. Banks accounted for the higher risk of these loans by a higher collateral margin.

¹⁴ A memorandum of understanding with Slovenia had been concluded, while discussions were in progress with the Czech Republic, Hungary and Slovakia.

23. **The authorities and the mission agreed that the planned reform of financial supervision should aim at strengthening regulatory capacity.** Adequate resources and operational independence were recognized as necessary conditions for effective supervision. Especially with a view to the growing number of Austrian banks' subsidiaries in CEECs and planned on-site inspections in these countries, banking supervision would most likely require additional staff to maintain its effectiveness. Views, however, differed as to the desirable institutional structure of supervision. The Ministry of Finance favored integrating supervision of financial markets in a new agency to eliminate the current institutional fragmentation of supervision and to anticipate financial market trends towards the formation of conglomerates.¹⁵ By contrast, officials of the OeNB thought that the present structure of financial markets (strongly segmented with no conglomerates) would not be well served by integrated supervision. The mission emphasized that ensuring sufficient authority, adequate instruments and full independence of the supervisor should take priority over the institutional setup. In particular, seeking political consensus on the institutional structure should not jeopardize the quality of supervision.¹⁶ The draft legislation submitted to parliament after the conclusion of the mission envisages integrated supervision of banking, securities, insurance companies and pension funds by a new, fully independent agency from April 1, 2002, with 90 percent of the costs covered by the private sector.

24. **The authorities considered the new capital market law (*Kapitalmarkt-offensivgesetz*, or KMOG) a useful step to improve the functioning of the capital market.** While acknowledging the mission's concerns that the new law's tax provisions discriminated between Austrian and foreign mutual funds and between equity and bond financing, the authorities stressed that the KMOG had reduced distortions in the capital market by abolishing the general tax on all capital market transactions.

III. STAFF APPRAISAL

25. **The Austrian economy performed well in 2000: strong growth was accompanied by falling unemployment and low inflation. Although there are no acute economic problems and the outlook is favorable, longer-term policy challenges remain.** The recent fiscal policy correction and steps to liberalize utilities are welcome, but a large public sector with a high tax burden, an underfunded social security system, and a heavily regulated economy cloud the horizon.

26. **The authorities' 2001–04 Stability Program has given new momentum to fiscal consolidation.** Against the background of persistent government deficits, high public debt,

¹⁵ Currently, supervisory responsibilities are shared by the Ministry of Finance, the Austrian National Bank, and the Securities Supervision Agency.

¹⁶ The proposed reform requires constitutional changes, and thus a two-thirds majority in parliament.