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The Tax Reform 2004-05 – Measures and Macroeconomic Effects

The tax reform 2004-05 has a total volume of about € 3 billion. It will decrease the income tax burden by almost € 2.2 billion and the corporate tax burden by € 1.1 billion; revenues from several excises taxes will be raised by € 232 million. On balance tax progression and revenue elasticity will rise. "Cold" progression will be compensated only partially. The preferential tax treatment of retained profits of sole-proprietorships and partnerships strengthens firms' internal financing capacities, but does not provide for financial neutrality. The corporate tax reform includes the reduction of the tax rate from 34 percent to 25 percent as of 2005 and the introduction of a group taxation which can be considered as attractive in international comparison. According to simulations of the short- und medium-term macroeconomic effects of the tax reform done with the WIFO macromodel, real GDP will be increased by almost 0.5 percent until 2008. The model simulations also show that the tax cuts will be self-financed through growth-induced additional tax revenues by 11 percent to 15 percent.

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Over the next few years, Austrian fiscal policy will be markedly influenced by the sizeable tax reductions brought about by the tax reform 2004-05. This reform is being implemented in two steps. The Austrian Parliament adopted the first tax reform package, which comprises a volume of almost € 0.5 billion (Table 1), in June, 2003. The second tax reform package was adopted in May, 2004; it includes measures which are worth over € 2.5 billion and will primarily take effect in 2005. Upon full effectiveness of all measures (from 2007 onwards) the tax reform 2004-05 will reduce the total tax burden by more than € 3 billion per year (1.2 percent of GDP). According to the latest Austrian Stability Programme of November 2003 (*Federal Ministry of Finance,* 2003) the tax reform will bring down the total tax ratio from 43.2 percent in 2003 to 41.9 percent of GDP in 2007.

The tax reform affects the wage and income tax, the corporate income tax, and several excise taxes. The originally intended introduction of provisions for the payment of lump-sum taxes to settle evaded taxes, combined with a tax amnesty, could not be put through. The major part of the tax cuts concerns wage and income taxation (almost € 2.2 billion). The corporate tax losses amount to € 1.1 billion, whereas the excise taxes will be raised by € 232 million (net). The article presents the measures taken within the tax reform 2004-05 in detail. Subsequently the macroeconomic effects as well as the degree of self-financing of the tax reform are estimated using the WIFO macromodel.

Table 1: Measures of the tax reform 2004-05

	2004	2005	2006	2007
		Million €		
Wage and income tax changes 2004-05	*– 529*	*– 1,851*	*– 2,223*	*– 2,173*
First phase 2004	– 329	– 601	– 793	– 793
Reform of income tax scale	– 320	– 380	– 380	– 380
Preferential tax treatment of retained profits	–	– 200	– 400	– 400
Tax-deductibility of tuition fees	–	– 3	– 3	– 3
Cross-border capital incomes	– 5	– 10	– 10	– 10
Tax-deductibility of installation costs of broadband internet access	– 4	– 8	–	–
Second phase 2005	– 200	– 1,250	– 1,430	– 1,380
Reform of income tax scale	–	– 950	– 1,150	– 1,100
Surcharges sole earner and lone parent tax credit	– 160	– 240	– 200	– 200
Earnings limit sole earner tax credit	– 25	– 35	– 30	– 30
Church contributions	–	–	– 30	– 30
Commuting tax allowance	– 15	– 25	– 20	– 20
Corporate tax changes 2005	–	*– 500*	*– 1,575*	*– 1,100*
Corporate tax scale reduction (net)[1]	–	– 500	– 1,450	– 975
Group taxation	–	–	– 100	– 100
Actuarial reserves of insurance companies	–	–	– 25	– 25
VAT and excise tax changes 2004-05	*+ 300*	*+ 295*	*+ 232*	*+ 232*
First phase 2004	+ 300	+ 310	+ 310	+ 310
VAT (on mineral oil tax, energy taxes)	+ 200	+ 240	+ 240	+ 240
Mineral oil tax	+ 135	+ 117	+ 117	+ 117
Energy taxes	+ 40	+ 43	+ 43	+ 43
Road-transport levy	– 75	– 90	– 90	– 90
Second package 2005	–	– 15	– 78	– 78
Sparkling wine tax	–	– 10	– 20	– 20
Beer tax	–	– 5	– 8	– 8
Mineral oil for diesel used for agricultural purposes	–	–	– 50	– 50
Total effects of the tax reform 2004-05	*– 229*	*– 2,056*	*– 3,566*	*– 3,041*
As a percentage of GDP	*– 0.1*	*– 0.9*	*– 1.4*	*– 1.2*
First phase 2004	– 29	– 291	– 483	– 483
Second phase 2005	– 200	– 1,765	– 3,083	– 2,558

Source: *Kaniovski – Schratzenstaller* (2004). + . . . tax increase, – . . . tax reduction. – [1] Tax loss due to tax rate reduction minus additional tax revenues due to tax-base broadening.

Wage and income taxation

Reform of the income tax scale

The lion's share in the reduction of the wage and income tax burden is effected by the reform of the income tax scale. Within the first step of the tax reform 2004 the standard tax credit is raised from 887 € to 1,264 €. The calculation formula used to phase out the standard tax credit is simplified considerably. The standard tax credit is reduced to zero at an income of 35,511 € (previously 35,421 €). This first step of the tax reform leaves a taxable income of 10,000 € and a gross income of 14,500 € per year untaxed for employees. For the self-employed a yearly gross income of 8,888 € (12,500 € for pensioners) remains tax-exempt.

With the second tax reform phase 2005 the standard tax credit is integrated into the regular income tax scale (*Gierlinger – Müller,* 2004). Table 2 contains the basic elements of the tax scale 2005. The tax scale, which at present is represented as a marginal tax rate scale, will be depicted as an average tax rate scale. Two average tax rates and the matching amount of tax payable are assigned to the two corresponding taxable incomes. As in the present tax scale, taxable incomes above 51,000 € are subject to a top marginal income tax rate of 50 percent. The tax scale is reduced by one tax bracket to four tax brackets and rests on three marginal tax rates (38.33 percent, 43.6 percent, and 50 percent). Yearly gross incomes of 15,770 € for employees, of 10,000 € for self-employed and of 13,500 € for pensioners are tax-exempt.

Table 2: Income tax scale 2005

Taxable income[1]) In €	Tax payable In €	Average tax rate In percent	Income bracket[1]) In €	Marginal tax rate In percent	Formula (tax payable in €)
Up to 10,000	0	0	Up to 10,000	0	
25.000	5,750	23	10,001 to 25,000	38.33	$\frac{(\text{Income}-10{,}000)\text{x}\,5{,}750}{15{,}000}$
51.000	17,085	33,5	25,001 to 51,000	43.59615	$\frac{(\text{Income}-25{,}000)\text{x}\,11{,}355}{26{,}000}+5{,}750$
Above 51,000	–	–	Above 51,000	50	$(\text{Income}-51{,}000)\times 0.5+17{,}085$

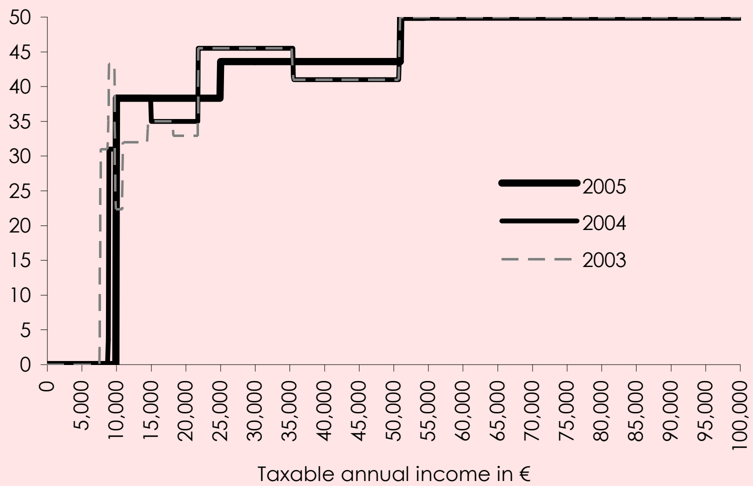
Source: Federal Ministry of Finance. – [1]) Taxable income (excluding 13th and 14th monthly payment), after all deductions (e.g., social security contributions, work-related expenses, special expenses). The standard tax credit is already integrated into the tax scale.

The negative tax within the employee tax credit remains unchanged. Against 2003, however, the income bracket within which taxpayers are entitled to negative tax payments is extended. In 2003, the maximum negative tax of 110 € per year was paid up to a taxable income of 8,400 € for employees. Above a taxable income of 8,800 € the income tax liability became positive. According to the tax scale 2005 the income limit for the maximum negative tax is 10,600 € (2004: 9,600 €). From 2005 on a positive income tax liability arises above a taxable income of 10,900 € (2004: 10,000 €).

The present tax scale is characterised by fluctuating effective marginal tax rates, which is the consequence of the calculation rules used to gradually phase out the standard tax credit. The 2005 income tax scale reform provides for a systematic progression of (effective) marginal tax rates across taxable incomes: (effective) marginal income tax rates climb gradually (Figure 1). Formal and effective tax rates (which include the standard tax credit) are identical. Thus the new tax scale is more transparent and simpler than the present one.

Figure 1: Effective marginal tax rates

Tax payable on every additional income of 100 € in percent



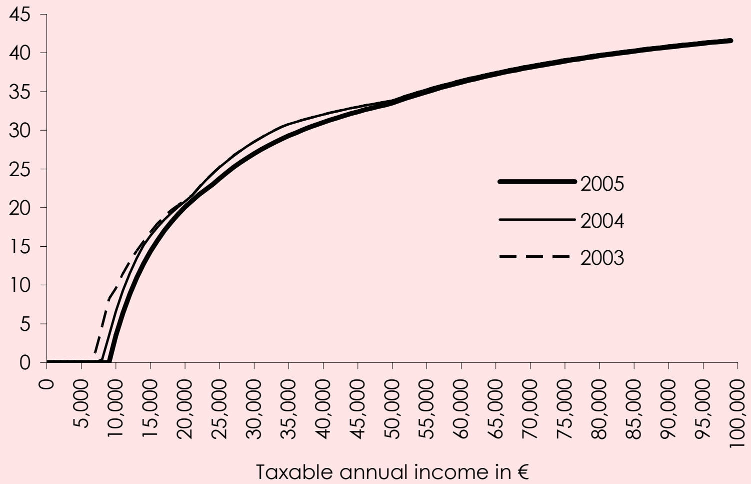
Source: Federal Ministry of Finance, WIFO calculations. Employee without sole earner or lone parent tax credit, employee and traffic tax credit, including standard tax credit.

The basic tax rate remains high (38.33 percent), but falls below that of the tax scale 2003 by almost 5 percentage points. Moreover the size of the fully tax-exempt income (10,000 € for employees) has to be taken into account when judging the level of the basic income tax rate.

The integration of the standard tax credit into the income tax scale smoothes the progression of the average tax rates (Figure 2).

Figure 2: Average tax rates

Tax payable as a percentage of taxable income



Source: Federal Ministry of Finance, WIFO calculations. Employee without sole earner or lone parent tax credit, employee and traffic tax credit, including standard tax credit.

This explains the distribution of the tax cuts across individual incomes, which at first sight seems rather erratic (Table 3 and Figure 3).

For employees the individual tax reduction in absolute terms is highest at a taxable income of 11,000 € (671.20 €); it gradually decreases with rising income to 144.60 € (at a taxable income of 22,000 €). The tax reduction rises again up to a taxable income of 35,000 € where it amounts to 550 €. For higher incomes it declines continuously until it reaches a constant level of 163.50 € above an income of 51,000 €. The relative tax cuts – in relation to taxable incomes – accordingly reach a maximum at an income of 11,000 € (–6.10 percent), above a taxable income of 35,000 € the relative individual tax reduction gradually decreases.

The new tax scale will exempt about 2.55 million taxpayers (out of 5.9 million) from taxation. Thus the two tax reform packages will reduce the number of taxpayers by 350,000 compared to 2003: –200,000 due to the 2004 reform, and another –150,000 due to the 2005 reform.

From a distributive as well as from a budgetary point of view the degree of progression of the new tax scale (represented by the ratio of the effective marginal tax rate to the average tax rate) is of interest. Compared to 2003 the degree of progression will increase considerably in the lower and middle income brackets (between 10,001 € and 20,000 €, Table 4).

This results from the combination of a high marginal tax rate and (because of the relatively high tax-exempt income) rather low average tax rates. Above this income bracket the degree of progression barely exceeds that of 2003. The degree of progression is fiscally relevant as it reflects the elasticity of wage and income tax revenues. Due to the steeper tax progression in almost all income brackets the overall elasticity of wage and income tax revenues will increase in future: The rise in taxable incomes will result in a larger increase in wage and income tax revenues. The degree of progression (including the employee and the traffic tax credit) will rise from 1.82 to 2.18 at an average income (19,270 € in 2003, 20,149 € in 2005). Thus a wage increase of 1 percent will raise tax revenues by 2.18 percent.

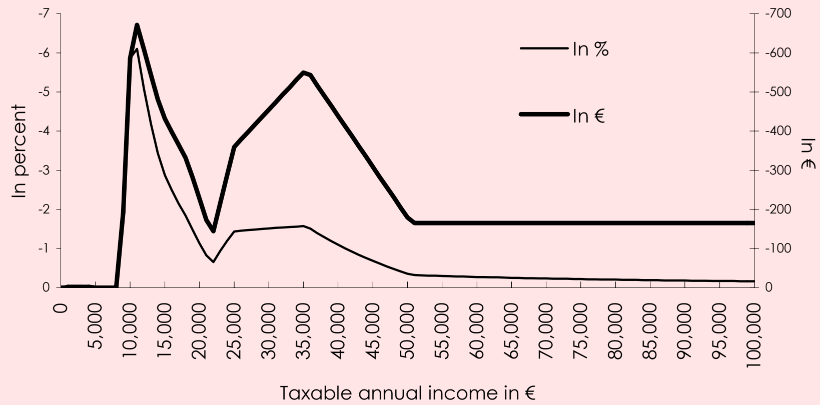
Table 3: Tax reduction 2005 against 2003

Employee without sole earner or lone parent tax credit, including employee and traffic tax credit

Taxable annual income	2003	2005	Change of tax burden 2003-2005	
In €	Average tax rate as a percentage of taxable income		In percent	In €
8,000	– 1.4	– 1.4	± 0.0	± 0.0
9,000	0.9	– 1.2	– 2.1	– 193.0
10,000	4.8	– 1.1	– 5.9	– 586.3
11,000	6.5	0.3	– 6.1	– 671.2
12,000	8.6	3.5	– 5.1	– 607.8
13,000	10.4	6.2	– 4.2	– 544.4
14,000	11.9	8.5	– 3.4	– 481.0
15,000	13.4	10.5	– 2.9	– 431.6
16,000	14.7	12.2	– 2.5	– 398.5
17,000	15.9	13.8	– 2.1	– 365.3
18,000	17.0	15.1	– 1.8	– 332.2
19,000	17.8	16.3	– 1.5	– 281.6
20,000	18.6	17.4	– 1.1	– 227.6
21,000	19.3	18.4	– 0.8	– 173.5
22,000	20.0	19.3	– 0.7	– 144.6
23,000	21.1	20.2	– 0.9	– 216.3
24,000	22.1	20.9	– 1.2	– 287.9
25,000	23.1	21.6	– 1.4	– 359.6
30,000	26.8	25.3	– 1.5	– 454.8
35,000	29.5	27.9	– 1.6	– 550.0
40,000	31.0	29.9	– 1.1	– 439.2
45,000	32.1	31.4	– 0.7	– 309.4
50,000	33.0	32.6	– 0.4	– 179.6
51,000	33.1	32.8	– 0.3	– 165.3
60,000	35.7	35.4	– 0.3	– 165.3
80,000	39.3	39.1	– 0.2	– 165.3
100,000	41.4	41.2	– 0.2	– 165.3

Source: Federal Ministry of Finance, WIFO calculations.

Figure 3: Tax reduction 2005 against 2003



Source: Federal Ministry of Finance, WIFO calculations. Employee without sole earner or lone parent tax credit, including employee and traffic tax credit

Table 4: Degree of progression

Taxable income	Excluding employee and traffic tax credit			Including employee and traffic tax credit		
	2003	2005	2003-2005	2003	2005	2003-2005
In €	Ratio of marginal tax rate to average tax rate		Difference in percentage points	Ratio of marginal tax rate to average tax rate		Difference in percentage points
10,100	2.66	95.83	+ 93.17	4.57	0	– 4.57
11,000	3.33	10.95	+ 7.62	4.77	54.76	+ 49.99
12,000	2.78	5.99	+ 3.21	3.72	10.95	+ 7.23
14,000	2.22	3.48	+ 1.26	2.69	4.51	+ 1.82
16,000	2.07	2.66	+ 0.59	2.38	3.14	+ 0.76
18,000	1.85	2.25	+ 0.40	2.06	2.54	+ 0.48
20,000	1.62	2.0	+ 0.38	1.77	2.20	+ 0.43
25,000	1.86	1.90	+ 0.04	1.97	2.02	+ 0.05
30,000	1.63	1.65	+ 0.02	1.70	1.72	+ 0.02
35,000	1.49	1.51	+ 0.02	1.54	1.56	+ 0.02
40,000	1.29	1.42	+ 0.13	1.32	1.46	+ 0.14
45,000	1.25	1.35	+ 0.10	1.28	1.39	+ 0.11
50,000	1.22	1.31	+ 0.09	1.24	1.34	+ 0.10
60,000	1.38	1.39	+ 0.01	1.40	1.41	+ 0.01
70,000	1.31	1.32	+ 0.01	1.33	1.33	± 0.00
80,000	1.26	1.27	+ 0.01	1.27	1.28	+ 0.01
90,000	1.23	1.23	± 0.00	1.23	1.24	+ 0.01
100,000	1.20	1.20	± 0.00	1.21	1.21	± 0.00

Source: Federal Ministry of Finance, WIFO calculations.

Table 5 shows the changes of residual income elasticities brought about by the income tax reform 2005. The residual income elasticity measures the extent to which an increase in taxable income raises the after-tax income. It is the lower the higher the degree of progression and therefore serves as another important measure of the progressivity of the tax scale. A progressive tax scale exhibits a residual income elasticity below 1, i.e., an increase of taxable income by 1 percent raises the after-tax income by less than 1 percent. Due to the expansion of the tax-exempt income bracket the residual income elasticity is 1 up to a taxable income of 10,000 €. It then exhibits a sharp decrease (to 0.62 for an income of 11,000 €) to increase again subsequently. At a taxable income of 50,000 € the residual income elasticity reaches 0.84. In the income brackets between 11,000 € and 21,000 € as well as between 36,000 € and 50,000 € it is lower, between 22,000 € and 35,000 € it is higher than in 2003. Above 51,000 € residual income elasticities of the tax scales 2003 and 2005 are aligning.

Finally we analyse whether the tax scale 2005 will eliminate fiscal drag: i.e., the problem that a progressive tax scale increases the real tax burden also in the case of nominal wage increases which are only intended to compensate for the loss of purchasing power caused by inflation. To determine the effect of "cold" progression average tax rates on nominal incomes are compared to those on the corresponding real incomes (deflated by the consumer price index) for a certain base year. This comparison shows whether and to what extent the tax scale 2005 will achieve a reduction of the tax burden on real incomes and thus a compensation for fiscal drag. Naturally the choice of the base year decisively influences the result of this comparison.

The results of the analysis conducted refer to two base years: 2003 and 2000 (the year in which the latest relevant reform of the income tax scale was carried through). Table 6 shows that up to a taxable income of 50,000 € fiscal drag could be eliminated completely compared to 2003. The picture is different for the base year 2000: a compensation for "cold" progression is accomplished only for incomes between 10,000 € and 16,000 €; below and above this income bracket the new tax scale 2005 cannot eliminate fiscal drag. In this context it must be pointed out that (due to budgetary constraints) the income limit above which the top income tax rate applies and which has remained constant since 1989 will not be raised.

Table 5: Residual income elasticities

Employee without sole earner or lone parent tax credit, including employee and traffic tax credit

Taxable annual income In €	Change of after-tax income if taxable income is raised by 1 percent 2003	2005
In €	In percent	
4,000	+ 1.00	+ 1.00
5,000	+ 0.98	+ 0.98
6,000	+ 0.98	+ 0.98
7,000	+ 0.98	+ 0.98
8,000	+ 0.99	+ 0.99
9,000	+ 0.57	+ 0.99
10,000	+ 0.82	+ 0.99
11,000	+ 0.73	+ 0.62
15,000	+ 0.75	+ 0.69
20,000	+ 0.82	+ 0.75
21,000	+ 0.83	+ 0.76
22,000	+ 0.68	+ 0.76
23,000	+ 0.69	+ 0.77
24,000	+ 0.70	+ 0.78
25,000	+ 0.71	+ 0.72
30,000	+ 0.74	+ 0.75
35,000	+ 0.77	+ 0.78
36,000	+ 0.84	+ 0.79
40,000	+ 0.85	+ 0.80
50,000	+ 0.88	+ 0.84
60,000	+ 0.78	+ 0.77
80,000	+ 0.82	+ 0.82
100,000	+ 0.85	+ 0.85

Source: Federal Ministry of Finance, WIFO calculations.

Table 6: Taxation of comparable real incomes

Employee without sole earner or lone parent tax credit, including employee and traffic tax credit

Taxable annual income 2005 In €	2000	2003
	Difference between average tax rate 2005 and the average tax rate for a corresponding real income Percentage points	
9,000	+ 0.11	– 0.82
10,000	– 1.91	– 4.82
11,000	– 3.91	– 5.41
12,000	– 2.26	– 4.18
13,000	– 1.60	– 3.37
14,000	– 1.03	– 2.68
15,000	– 0.54	– 2.08
16,000	– 0.12	– 1.72
17,000	+ 0.08	– 1.43
18,000	+ 0.26	– 1.16
19,000	+ 0.43	– 0.91
20,000	+ 0.57	– 0.60
21,000	+ 0.80	– 0.31
22,000	+ 1.01	– 0.05
23,000	+ 1.20	– 0.02
24,000	+ 1.36	– 0.32
25,000	+ 1.12	– 0.59
30,000	+ 1.05	– 0.81
40,000	+ 0.54	– 0.72
50,000	+ 0.75	– 0.06
55,000	+ 1.29	+ 0.29
60,000	+ 1.31	+ 0.27
80,000	+ 0.98	+ 0.20
100,000	+ 0.78	+ 0.16

Source: Federal Ministry of Finance, WIFO calculations. + . . . fiscal drag not compensated, – . . . fiscal drag overcompensated.

Preferential tax treatment of retained profits

To promote the formation of own equity, the tax reform package 2004 introduced the preferential tax treatment of retained profits of sole proprietorships and partnerships. This provision replaces the preferential tax treatment of the notional interest on incremental own equity. Retained profits which lead to an increase in own equity are taxed at half the average income tax rate. Due to budgetary constraints and because small and medium-sized enterprises in particular are to be supported, the tax privilege is granted up to a maximum yearly amount of retained profits of 100,000 € only. Moreover, the additional own equity has to remain within the enterprise for a period of seven years, otherwise it is subject to subsequent regular taxation.

This new regulation is justified by the fact that small and medium-sized Austrian enterprises on average are undercapitalised. Thin capitalisation considerably increases the risk of bankruptcy during cyclical downswings. Moreover, insufficient own equity restricts entrepreneurs' willingness and ability to accept risks and thus may dampen the innovative potential of an economy as a whole (*Lehner,* 2003).

However, the preferential tax treatment of own equity is only a first step towards financial neutrality of the income tax system. The Austrian income tax system discriminates against own equity: While interest paid on debt as operating expenses reduces taxable profits, interest on own equity is not tax-deductible. Tax privileges for retained profits cannot eliminate this distortion of financial neutrality. Rather, a financially neutral income tax system requires the tax-deductibility of interest on the whole stock of own equity (*Staringer,* 2003).

The preferential tax treatment of retained profits may also curb capital market efficiency. If retained profits are privileged against distributed respectively withdrawn ones, capital may be kept within the enterprise even if more profitable investment possibilities exist outside the enterprise (*Beer et al.,* 2004). This "lock-in effect" may be reinforced by the requirement of a seven-year period during which additional own equity financed by retained profits must remain within the enterprise to become eligible for the tax privilege. Another potential drawback may be the rather complicated design of the provision, which by the way was also a problem of the previously granted preferential tax treatment of the notional interest on incremental own equity (*Lehner,* 1999).

Moreover, the potential to keep profits within the enterprise is restricted for small enterprises, which are particularly poorly endowed with own equity. For these enterprises the effectiveness of tax instruments aimed at promoting the formation of own capital is likely to be limited, because entrepreneurs have to withdraw a considerable share of profits to provide for their living expenses. Entrepreneurs whose incomes do not exceed the tax-exempt amount do not profit at all from the provision (85,000 in 2004; *Lehner,* 2003). Thus the new regulation is only one element to support undercapitalised small and medium-sized enterprises. With respect to the increased capital market barriers which "Basle II" may imply for these enterprises it seems advisable to amend this provision by non-tax-related additional measures.

Finally the tax privilege is not neutral with respect to the organisational form of firms: neither regarding incorporated firms versus sole proprietorships and partnerships, nor within the group of enterprises subject to income taxation, as the preferential tax treatment of retained profits is not granted to the self-employed. The tax discrimination between different organisational forms of firms will be aggravated further by the oncoming reduction of the corporate tax rate: as of 2005, distributed profits of incorporated firms will be taxed at 43.75 percent (corporate tax rate of 25 percent plus final dividend tax of 25 percent), while the top marginal income tax rate for withdrawn profits will remain at 50 percent for the non-incorporated enterprise sector. This problem is defused somewhat, however, by the fact that the majority of business income earners are not subject to the top income tax rate.

Further measures within wage and income taxation

Both tax reform packages contain several additional tax relief provisions. The first tax reform step 2004 introduces the tax-deductibility of installation costs and basic charges for broadband internet access (in effect until the end of 2004). As one element of a strategy to encourage life-long learning tuition fees are made tax-deductible for studies conducted as in-service training or studies which qualify as retraining measure. This tax relief is a useful complement of the tax allowances and premia for retraining measures offered by enterprises, which were introduced and extended, respectively, with the tax reform 2000 and the stimulus and growth packages adopted in the past years. Furthermore, the taxation of cross-border capital incomes (interest and dividends) has been aligned to the taxation of domestic capital incomes: now these foreign capital incomes are also subject to a final tax of 25 percent.

With the second tax reform phase 2005, monetary transfers to families are expanded further, a change which strengthens the existing predominance of monetary transfers within Austrian family policy. The tax credit for sole earners and lone parents (364 €), respectively, is supplemented by surcharges increasing with the number of children and paid out as a negative tax to low-income families. The surcharge comes to 130 € for the first, 175 € for the second and 220 € for each subsequent child. For lone parents, who are exposed to an above-average poverty risk (*Guger et al.,* 2003), this measure is to be judged positively.

At the same time the spouse's earnings limit, up to which the sole earner tax credit is granted, is raised from 4,400 € to 6,000 € for two-parent families with at least one child. De facto, the combination of (increased) sole earner tax credits and a (higher) earnings limit amounts to the promotion of precarious employment (as a rule of the mother), which may well have some impact on labour market decisions at the lower income brackets and for the lower qualification segments. The improvement of the reconciliation of work and family life, which the European employment strategy and the Lisbon process call for with the intent to boost female labour market participation, requires a corresponding expansion of family- and child-related real transfers in the future (*OECD,* 2003).

Also as of 2004, the commuter tax allowance, which is granted in addition to the traffic tax credit, is increased by 15 percent. From 2005 on church contributions are tax-deductible up to a yearly amount of 100 € (at present 75 €).

Corporate taxation

Measures within the system of corporate taxation

The major part of the envisaged corporate tax relief is accounted for by the reduction of the statutory corporate tax rate from 34 to 25 percent as of 2005. This change can be interpreted as a reaction to the intensification of European tax competition brought about by the eastern enlargement of the EU. Table 7 contains the statutory corporate tax rates for the member states of the enlarged EU. By comparison with the EU 15 the Austrian corporate tax rate will be below average in 2005, by comparison with the new member countries it is still somewhat above average.

The corporate tax rate cut is financed to some extent by two tax-base broadening measures. First, the preferential treatment of notional interest for incremental own equity is abolished. Second, the tax-neutral transfer of hidden reserves or the set-up of a transfer reserve for assets taken out of the stock of current assets is not permitted any more to corporations. Both measures taken together account for an increase of the tax burden of € 195 million. At the bottom line the corporate tax rate reduction eases the tax burden by € 975 million.

For insurance companies the tax-deductibility of actuarial reserves (loss reserves) is extended: from 2005 on only 6 percent (instead of 14 percent at present) of reserves set up to cover still outstanding damage events are not accounted for.

Table 7: Statutory corporate tax rates in EU 25

	2003	2005
	In percent	
Belgium	34.0	34.0
Denmark	30.0	30.0
Germany	27.9	26.4
Greece[1]	25.0 or 35.0	25.0 or 35.0
Spain	35.0	35.0
France	35.4	35.4
Ireland	12.5	12.5
Italy	34.0	34.0
Luxembourg	22.9	22.9
The Netherlands	34.5	34.5
Austria	34.0	25.0
Portugal	30.0	30.0
Finland	29.0	26.0 [2]
Sweden	28.0	28.0
UK	30.0	30.0
EU 15 average	30.1	29.2
Czech Republic	31.0	26.0
Estonia[3]	0.0 or 26.0	0.0 or 26.0
Cyprus[4]	10.0 or 15.0	10.0 or 15.0
Latvia	19.0	15.0
Lithuania	15.0	15.0
Hungary	18.0	16.0
Malta	35.0	35.0
Slovenia	25.0	25.0
Slovakia	25.0	19.0
Poland	27.0	19.0
Bulgaria	23.5	19.5
Romania	25.0	25.0
Accession (candidate) countries average	21.5	19.1
EU 25 and candidate countries average	26.3	24.7

Source: *Schratzenstaller* (2004). Including surcharges, excluding local taxes. – [1] 25 percent for non-incorporated enterprises, which are subject to corporate taxation in Greece, 35 percent for corporations and financial institutions. – [2] Not yet adopted. – [3] Retained profits and distributed profits. – [4] 15 percent for profits above £ 1 million.

Introduction of a group taxation

The current provisions to offset inter-company profits and losses (the "Organschaft") within corporate taxation is replaced by a group taxation based on – also in European comparison – quite liberal conditions (*Gassner,* 2004). The requirement to conclude a profit-pooling contract is dropped. The only prerequisite is a financial engagement of at least 50 percent; the group member does not need to be organisationally and economically integrated any more. The group members are required to stay in the group for a period of at least three years if subsequent taxation is to be avoided.

Very remarkable is the option to include also foreign affiliates and their losses, which at present is offered by very few European countries only, e.g., Denmark (*Watrin – Sievert – Strohm,* 2004). Foreign losses cannot be offset in Austria, however, if and when they can be used in the source country. When the foreign group member leaves the group subsequent taxation takes place. The result in the source country is determined on the basis of Austrian corporate tax laws which may cause sizeable administrative costs.

These group taxation provisions are complemented by the introduction of a depreciation allowance for goodwill (*Kohlhauser – Wette,* 2004): For domestic shares acquired to integrate a firm into a group the goodwill (the size of which is limited to 50 percent of the purchase price) can be written off over a period of 15 years. Thus share deals (purchase of shares) and asset deals (merger or acquisition by the purchase of individual assets) will be treated equally in future.

Consumption taxes

With the first step of the tax reform 2004 the 13th VAT instalment rate was abolished which caused a one-off tax loss of € 1.7 billion in 2003. In addition, the import turnover tax was reformed, resulting only in a one-off tax loss of € 400 million in 2003 as well. As both measures bring about one-off tax losses only they do not appear in Table 1.

With the introduction of road pricing for motor vehicles with a total registered weight of more than 3.5 tonnes, the 2004 tax package also abolished the road-transport levy. Moreover, the tax rates on mineral oil and natural gas were increased, and a coal tax was implemented. Table 8 informs about the Austrian energy tax rates.

Table 8: Energy tax rates

	Unit	EU minimum tax rate 2004		Austria			Germany
		Enterprises	Private households	1996	2000	2004	2004
		€ per unit		€ per unit	€ per unit	€ per unit	€ per unit
Electricity	kWh	0.0005	0.001	0.007	0.015	0.015	0.0205
Natural gas (heating)	m³	0.0054 [1]	0.0108 [1]	0.0436	0.0436	0.066	0.0546 [3]
Coal	kg	0.004 [2]	0.008 [2]	–	–	0.05	0
Liquid gas (heating)	kg	0		0.043	0.043	0.043	0.061
Gasoline unleaded	l	0.359		0.407 [4]	0.407	0.432 or 0.417 [5]	0.6698 or 0.6545
Diesel	l	0.302		0.282 [4]	0.282	0.317 or 0.302 [5]	0.4857 or 0.4704 [5]
Fuel oil[6]	kg	0.015		0.036 [4]	0.036	0.06	0.025 or 0.061 [7]
Liquid gas (fuel)	kg	0.125		0.261	0.261	0.261	0.161

Source: EU Directive 2003/96/EG, DIW, Budgetbegleitgesetz (budget law) 2003, WIFO calculations. – [1] EU Directive for natural gas: private households 0.3 € per GJ, enterprises 0.15 € per GJ. – [2] EU Directive for coal: private households 0.3 € per GJ, enterprises 0.15 € per GJ. – [3] 1.5 € per GJ. – [4] As of 1 May 1995. – [5] Depending on sulphur content. – [6] Light, medium, and heavy. – [7] Light and heavy.

The (rather low) minimum tax rates the EU member states have agreed on in 2003 are exceeded for all fossil energy sources. Compared to Germany mineral oil taxes are still considerably lower so that "fuel tourism" from Germany can be expected to play a certain role also in the future.

The 2005 tax package includes the reduction of the tax rate on diesel used for agricultural purposes from 0.302 € per litre to 0.098 € per litre. The beer tax will be slightly reduced from 2.08 € to 2 € per degree Plato. As of April 2005, the tax on sparkling wine will be abolished (currently 1.44 € per litre).

Simulation of the macroeconomic effects of the tax reform with the WIFO macromodel

The tax reform on the one hand eases the tax burden for private households by strengthening disposable incomes through wage and income tax cuts. On the other hand the substantial corporate tax rate cut decreases the user costs of capital and stimulates additional gross investment. Subsequently multiplier and accelerator effects reinforce this positive stimulus to the demand for consumption and investment goods. The results are summarised in Table 9[1].

The reduction of income and property taxes increases real disposable incomes of private households by 0.3 percent in 2004. In the following years the tax cuts cause a cumulative increase of disposable incomes by about 2 percent. As the consumption function implies an average short-run propensity to consume of 0.6, the increase of disposable incomes leads to a strong growth of private consumption by about 1.5 percent in the medium term. The saving ratio rises by 0.6 percentage points in the first two years; however, in the medium term (until 2008) the effect goes back to +0.2 percentage point. The exogenous components of public expenditures, particularly public consumption and investment, are not affected by the tax reform.

The concept of user costs of capital is used to estimate the impact of the tax reform on private investment (*Kaniovski,* 2002). Neoclassical investment theory assumes profit-maximising firms; user costs of capital equal the marginal productivity of the factor capital. Within this theoretical framework, the effects of individual tax instru-

[1] The calculations presented are based on a study commissioned by the Association of Austrian Cities and Towns (Österreichischer Städtebund).

ments (e.g., depreciation rules, corporate tax rates, etc.) on firm investment can be analysed.

As a consequence of the corporate tax rate cut the user costs of capital decrease from 20.1 to 19.6 percent[2]. Together with the multiplier effects the tax cut raises gross fixed investment by 0.5 percent in 2005 (compared to a baseline scenario without tax reform), by 0.9 percent in 2006, and by 0.8 percent in the two subsequent years. The expansion of gross investment is mainly accounted for by the rise in investment in equipment (2005 +0.8 percent, 2008 +1.2 percent), while the effect of the tax cut on investment in buildings is less expansionary (2008 +0.5 percent). In addition to these investment effects the corporate tax rate cut may increase Austria's locational attractiveness (*Breuss – Schratzenstaller,* 2004) and thus attract additional foreign investment or prevent the outflow of domestic investment. As such effects cannot be captured by the WIFO macromodel the simulations presented above may underestimate the actual (total) investment effects.

Table 9: Macroeconomic effects of the tax reform 2004-05

		2004	2005	2006	2007	2008
		Cumulative deviations from a baseline scenario without tax reform in percent				
Demand, real (at 1995 prices)						
Consumption expenditures		+ 0.13	+ 0.67	+ 1.16	+ 1.16	+ 1.24
Private Households[1]		+ 0.18	+ 0.89	+ 1.51	+ 1.50	+ 1.60
State		– 0.02	– 0.01	+ 0.00	+ 0.01	+ 0.02
Gross fixed investment		+ 0.10	+ 0.46	+ 0.85	+ 0.80	+ 0.82
Private investment in buildings		+ 0.05	+ 0.23	+ 0.42	+ 0.47	+ 0.51
Private investment in equipment		+ 0.16	+ 0.75	+ 1.37	+ 1.19	+ 1.17
Exports		+ 0.00	+ 0.00	+ 0.01	+ 0.01	+ 0.01
Imports		+ 0.12	+ 0.60	+ 1.03	+ 1.01	+ 1.06
Trade balance	as a percentage of GDP	– 0.07	– 0.34	– 0.61	– 0.62	– 0.68
GDP, real		*+ 0.06*	*+ 0.27*	*+ 0.45*	*+ 0.43*	*+ 0.43*
Nominal		*+ 0.12*	*+ 0.35*	*+ 0.52*	*+ 0.51*	*+ 0.54*
Prices						
Consumer prices		+ 0.06	+ 0.08	+ 0.06	+ 0.07	+ 0.09
Terms of trade		– 0.00	– 0.02	– 0.06	– 0.05	– 0.05
Labour market						
Labour supply		+ 0.01	+ 0.03	+ 0.04	+ 0.04	+ 0.04
Employees[2]		+ 0.03	+ 0.12	+ 0.14	+ 0.14	+ 0.14
	in 1,000	+ 0.89	+ 3.89	+ 4.56	+ 4.45	+ 4.36
Unemployment rate[3] [4]	percentage points	– 0.02	– 0.08	– 0.09	– 0.09	– 0.09
Unemployed[3])	in 1,000	– 0.61	– 2.69	– 3.16	– 3.10	– 3.04
Labour productivity		+ 0.03	+ 0.14	+ 0.31	+ 0.29	+ 0.30
Unit labour costs		– 0.00	– 0.10	– 0.26	– 0.23	– 0.22
Incomes, Savings						
Wage bill (gross)[5]		+ 0.06	+ 0.17	+ 0.20	+ 0.20	+ 0.21
Real wages per employee		– 0.03	– 0.03	– 0.01	– 0.00	– 0.01
Private sector		– 0.03	– 0.03	– 0.01	– 0.00	– 0.01
Disposable income of private households, net						
Nominal		+ 0.37	+ 1.50	+ 2.28	+ 1.94	+ 1.92
Real (at 1995 prices)		+ 0.30	+ 1.43	+ 2.22	+ 1.87	+ 1.83
Saving ratio[6]	percentage points	+ 0.04	+ 0.48	+ 0.62	+ 0.32	+ 0.19
Public budget						
Current revenues	as a percentage of GDP	– 0.12	– 1.48	– 2.52	– 2.00	– 1.93
Current expenditures	as a percentage of GDP	+ 0.00	– 0.00	– 0.01	– 0.00	+ 0.01
Budget deficit	as a percentage of GDP	– 0.06	– 0.73	– 1.23	– 0.98	– 0.95

Source: WIFO calculations. – [1] Including private non-profit institutions serving households. – [2] Excluding beneficiaries of parental leave or child care benefits and people in military service. – [3] According to Labour Market Service Austria. – [4] As a percentqge of dependent labour force. – [5] Excluding employers' contributions. – [6] As a percentage of disposable personal income.

The WIFO macromodel represents Austria as a small open economy. The demand for Austrian exports depends on foreign demand, which is exogenously given, as well as on relative export prices. The latter are changed by real unit labour costs only to a small extent: in the medium term the tax reform causes real unit labour costs to fall by 0.2 percent compared to the baseline scenario because real GDP grows

[2] This calculation does not consider the slight broadening of the tax base.

faster than the wage bill. The decrease of unit labour costs therefore only marginally improves the competitiveness of Austrian exports. The increase of domestic demand (consumption and investment) attracts additional imports (+1 percent) in the medium term. As a result of the expansion of import demand combined with a constant development of exports and almost constant terms of trade, the trade balance (current account) experiences a cumulative deterioration of 0.7 percent up to 2008.

Taxes in the WIFO Macromodel

The WIFO macromodel depicts the interrelations within the Austrian economy on a yearly basis. To examine the macroeconomic impact of, e.g., a tax reform dynamically over time, the model captures the most important relations between the domestic market and the rest of the world, the public sector, the labour market, and the price-wage system. The model includes the demand as well as the supply side. A production function represents the supply on the goods market.

The analysis of the effects of a tax reform requires a detailed representation of the public sector. The WIFO macromodel distinguishes between public revenues and expenditures. Public revenues are divided into three large categories in accordance with ESA 95: production and import taxes (indirect taxes: VAT and other production and import taxes), income and property taxes (direct taxes: wage and income tax, corporate tax, and other income and property taxes), and social security contributions (unemployment insurance contributions and other social security contributions).

Public revenues are exclusively determined endogenously in the model. They are either determined using elasticities of tax revenues with respect to the underlying macroeconomic variables, or the dynamics of the tax base are explicitly represented so that the effects of a variation of the tax base can be separated from those resulting from tax rate changes. Thus wage and income tax revenues are determined by the wage bill, VAT revenues depend on the development of private consumption, and corporate tax revenues are related to the net operating surplus. In contrast, public expenditures are largely set within the model, i.e., they are determined exogenously. Personnel expenses are the most important endogenous component of public expenditures.

The tax reform also increases excise taxes. Nonetheless consumer prices are not inflated significantly: as the direct impulse of the tax increase is dampened by the reduction of unit labour costs (–0.2 percent) the consumer price index rises by only 0.1 percent until 2008.

The positive demand shock immediately raises employment. In the medium term the cumulative increase in the number of employees amounts to 4,500 persons compared to the baseline scenario (+0.15 percent). As labour supply barely increases a cumulative decline in the number of unemployed by 3,000 persons can be expected until 2008. The unemployment rate according to the Austrian definition goes down by 0.1 percentage point. Per-capita wages in the private sector continue to rise only moderately so that the increase in the wage bill (+2 percent cumulative) until 2008 primarily is a result of employment growth.

Due to the tax reform the state loses up to € 3 billion or 2.5 percent of its current tax revenues. The tax loss at first fully affects the budget deficit which deteriorates by about 0.1 percent of GDP in 2004 and 0.7 percent of GDP in 2005. The maximum effect can be expected for 2006 (–1.2 percent of GDP). In the following years the budgetary strain gradually eases (additional budget deficit of –1 percent of GDP). This development of the budget deficit is mainly determined by the self-financing effects of the tax reform.

Degree of self-financing of the tax reform

To establish the degree of self-financing of the tax reform 2004-05 one has to distinguish between direct self-financing effects – i.e., additional revenues from those taxes which are varied within the tax reform – and indirect second-round effects (*Kaniovski – Schratzenstaller,* 2004). The latter primarily concern revenues from production and import taxes – which grow due to the additional consumption and import expenditures induced by the tax reduction –, and income and property tax revenues.

Table 10 presents the degree of self-financing, defined as the relation of direct and indirect self-financing effects (within wage and income tax and corporate tax) and the tax losses estimated by the Federal Ministry of Finance in the draft bills (Table 1). The magnitude of the self-financing effect depends on the demand effects of the tax reduction on the one hand and on the revenue elasticities of the individual taxes on the other hand. Within wage and income taxes additional revenues are created. If these effects are taken into account the actual tax losses that can be expected will be smaller than those estimated by the Federal Ministry of Finance. However, the corporate tax loss calculated with the WIFO macromodel will slightly exceed the estimated official figure: the depreciation connected with the additional investment stimulated by the corporate tax rate cut lowers taxable profits.

Table 10: Self-financing of tax reform 2004-05

Tax losses and additional revenues according to draft bills, minus self-financing effects

		2004	2005	2006	2007	2008
				Million €		
Production and import taxes						
VAT		+ 74	+ 181	+ 274	+ 280	+ 305
Draft bill		+ 40	+ 43	+ 43	+ 43	+ 43
Self-financing		+ 34	+ 138	+ 231	+ 237	+ 262
Other production and import taxes		+ 272	+ 285	+ 290	+ 295	+ 300
Draft bill		+ 260	+ 252	+ 189	+ 189	+ 189
Self-financing		+ 12	+ 38	+ 108	+ 113	+ 118
Total		+ 346	+ 471	+ 571	+ 582	+ 612
Draft bill		+ 300	+ 295	+ 232	+ 232	+ 232
Self-financing		+ 46	+ 176	+ 339	+ 350	+ 380
Income and property taxes						
Wage and income taxes		– 515	– 1,809	– 2,173	– 2,119	– 2,113
Draft bills		– 529	– 1,851	– 2,223	– 2,173	– 2,173
Self-financing		+ 14	+ 42	+ 50	+ 54	+ 60
Degree of self-financing	in percent	2.6	2.3	2.3	2.5	2.8
Corporate tax		± 0	– 517	– 1,597	– 1,101	– 1,129
Draft bill		± 0	– 500	– 1,575	– 1,100	– 1,100
Self-financing		± 0	– 17	– 22	– 1	– 29
Degree of self-financing	in percent	0.0	– 3.4	– 1.4	– 0.1	– 2.6
Other income and property taxes		+ 7	+ 21	+ 32	+ 32	+ 34
Self-financing		+ 7	+ 21	+ 32	+ 32	+ 34
Total		– 508	– 2,305	– 3,738	– 3,188	– 3,208
Draft bills		– 529	– 2,351	– 3,798	– 3,273	– 3,273
Self-financing		+ 21	+ 46	+ 60	+ 85	+ 65
Degree of self-financing	in percent	4.0	2.0	1.6	2.6	2.0
Total volume of the tax reform 2004-05		*– 162*	*– 1,839*	*– 3,174*	*– 2,613*	*– 2,603*
Draft bills		– 229	– 2,056	– 3,566	– 3,041	– 3,041
Self-financing		+ 67	+ 222	+ 399	+ 435	+ 446
Degree of self-financing	in percent	29.3	10.8	11.2	14.3	14.7

Source: WIFO calculations. + . . . tax increase, – . . . tax reduction.

The direct and indirect additional tax revenues yield a degree of self-financing (defined as the relation of the induced additional tax revenues and the official tax loss estimations according to the draft bills) from 11 to 15 percent in the period 2005 to 2008. In 2004 the degree of self-financing is extraordinarily high (30 percent): in this year relatively small net tax losses (tax losses due to the income tax cut offset by excise tax increases) are combined with high additional revenues from VAT and the other production and import taxes, to a lesser extent also from wage and income tax and the other income and production taxes.

Concluding remarks

The tax reform 2004-05 with its considerable tax reductions poses a great challenge to Austrian fiscal policy for the years to come: on the federal level as well as for states and municipalities. The latter are affected by tax losses according to their shares in shared federal tax revenues laid down in the Fiscal Equalisation Act of 2001, and they have to expect a reduction in tax revenue-dependent federal transfers. To achieve the goal of a balanced budget envisaged for 2008, the expenditure cuts (e.g., within public administration, the health system, or public subsidies) which are necessary to finance the tax reductions have to be defined more clearly. The success of a strategy intending to depress the tax ratio without at the same time endangering the consolidation of public budgets will crucially depend on the implementation of important reform projects, for example the expenditure-saving redesign of the division of tasks between the governmental levels which is currently debated in the Austrian convention.

The tax reform is a substantial element within the government's long-term strategy to bring down the tax ratio to 40 percent by the year 2010. The achievement of this goal calls for additional tax cuts. Hereby it seems advisable to put the focus on supplementary labour costs as this would avoid the danger of potentially procyclical tax cuts. Such a change is also suggested by the Austrian tax structure: the tax ratio excluding social security contributions equals that of the EU 15, while the tax ratio including social security contributions is still considerably above average.

Future tax reforms will have to account for structural reform needs further on (*Schratzenstaller,* 2003). Property and energy taxation will have to be discussed, as well as possibilities to ease the tax burden for high incomes (top income tax rate and top taxable income, respectively) and options to introduce targeted work incentives for low incomes into the tax system. The financing of tasks which concern the society as a whole (the support of families or the promotion of residential building) through payroll taxes should also be critically examined.

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The Tax Reform 2004-05 – Measures and Macroeconomic Effects

Summary

The tax reform 2004-05 includes tax cuts within income taxation (€ –2.2 billion) and corporate taxation (€ –1.1 billion) as well as increases of several excise taxes (€ +232 million). It is realised in two steps: the first tax reform package, taking effect in 2004, was adopted by the Austrian Parliament in June 2003 and reduces the tax burden by almost € 0.5 billion. The measures of the second package, which are worth about € 2.5 billion, were adopted in May 2004 and will mostly be implemented in 2005. The total volume of the tax reform 2004-05 reaches about € 3 billion (1.2 percent of GDP) from 2007 on. The tax reform is an important element within the government's long-term strategy to bring the tax ratio down to 40 percent of GDP. According to the current Austrian Stability Programme, the tax reform will decrease the tax ratio from 43.2 percent in 2003 to 41.9 percent of GDP in 2007.

The reform of the tax scale accounts for the lion's share of the wage and income tax cuts. Within the first step of the tax reform 2004, the standard tax credit was increased from a maximum of 887 € to a maximum of 1,264 €. From 2005 on, the standard tax credit will be integrated into the income tax scale. The tax scale, which up to now is represented as a marginal tax rate scale, will be depicted as an average tax rate scale and will be reduced to four tax brackets. The reform eases the tax burden for all taxpayers. The income tax scale is made more systematic and transparent by the reform of 2005: marginal tax rates are increasing gradually with taxable income; formal and effective marginal tax rates will be identical. At the same time, the changes in the tax scale result in steeper tax progression.

The income tax reform 2004 also introduces the preferential tax treatment of retained profits of sole proprietorships and partnerships: retained profits leading to an increase of own equity are taxed at half the average income tax rate (up to a maximum of 100,000 €). Within the second income tax reform phase, several special measures are implemented, which already take effect in 2004: surcharges to the tax credit for sole earners and lone parents are granted, and the commuting tax allowances are raised.

The largest part of the corporate tax cut is the result of the decrease of the corporate tax rate from 34 percent to 25 percent in 2005. Moreover, a very liberal group taxation is implemented, which allows companies to offset intercompany profits and losses (including losses incurred by foreign affiliates) and which will considerably promote Austria's attractiveness as a headquarter location.

With the first step of the tax reform 2004, tax rates on mineral oil and natural gas were raised and a coal tax was introduced. In 2005, the tax rate on diesel oil used for agricultural purposes will be cut significantly. The tax on sparkling wine will be abolished and the beer tax will be slightly reduced.

According to simulations done with the WIFO macromodel, a short-term increase of 0.3 percent and a medium-term increase of 0.4 percent of real GDP can be expected, as the tax reform strengthens disposable incomes of private households and decreases user costs of capital for corporations. The increase of domestic consumption boosts employment by 4,300 persons, the unemployment rate falls by 0.1 percentage points in the medium term. The tax cuts will lead to a temporary increase of the budget deficit of up to 1.2 percentage points. The degree of self-financing is estimated at 11 percent to 15 percent.