Current Fiscal Developments in Austria against the Background of EU Requirements

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Conditions for a Broadly Based Economic Upturn Brighten

In 2013 through 2015, the global economy will grow only slowly (real GDP according to the IMF's forecast: 2013: +2.9%; 2014: +3.6%; 2015: +4.0%). The economic upswing in the U.S.A., annual growth rates of more than 5% in the emerging Asian economies and the reduction of macroeconomic imbalances in Europe herald improving economic conditions as well as a gradual end to the financial, economic and government debt crisis. The **euro area** is expected to have overcome the recession in the second quarter of 2013. The European Commission sees euro area GDP expanding by 1.1% in 2014 and 1.7% in 2015 year on year on the back of domestic demand. Not until 2015 is euro area GDP anticipated to recover to the 2008 level.

The current remaining disparities in terms of competitiveness, high unemployment in parts of Europe, the fragmentation of European financial markets and the need to cut government debt in Europe and the U.S.A. represent enormous challenges that need to be addressed through structural reforms and long-term growth initiatives. The risk of a renewed flare-up of the financial and debt crisis remains.

The **Austrian** economy is expected to revive in 2014 and 2015 following a phase of weakness from the first quarter of 2012 through the third quarter of 2013, with growth lying within a range of 1.5% to 2% (2013: +0.4%). Unlike in 2013, domestic demand should provide an impetus to economic growth in Austria in the coming years. Higher real disposable income – among other things because of lower inflation – and a rise in employment should be reflected in higher consumer spending. Also, investment demand, which contracted in 2013, should revive, given expectations of rising sales and the need for replacement investment. More animated domestic demand will fuel imports and will therefore decrease the contribution to growth of net exports year on year even though export demand is set to rise. Government consumption is expected to make a slight positive contribution to growth.

So far in 2013, **unemployment** has surged (by +25,000 persons from the first through the third quarters of 2013 year on year), even though **employment** has gone up substantially (by +28,000 persons from the first through the third quarters of 2013 year on year). Payroll employment is anticipated to augment noticeably again in 2014 and 2015. At the same time, the average number of registered unemployed persons is likely to increase again in 2014 (by more than +10,000). The **labor market**, which reacts to cyclical developments with a time lag, is characterized by a steady, strong influx of labor from EU countries. According to the European Commission, Austrian unemployment (as a percentage of the labor force) will come to 5.1% in 2013 and to 5.0% in 2014. The unemployment rate calculated to national standards (measured in terms of paid employment in accordance with the Main Association of Austrian Social Security Institutions) will reach 7.6% in 2013 and 7.8% in 2014 (Austrian Institute of Economic Research, October 2013).

Austrian Budget Balance to Improve despite Additional Expenditure

With the Austrian general government deficit target at **2.3% of GDP** (2012: 2.5% of GDP), the actual outcome **in 2013** should in fact be lower despite higher-than-expected capital injections for the banking sector and a weak economy. This outcome hinges on the following factors: Budget execution is strict; market interest rates are lower than expected, which eases the interest burden on the public debt; and additional, mainly one-off, revenues are high (e.g. EUR 0.7 billion generated by the tax agreement with Switzerland and EUR 2.0 billion by the multiband auction). In its most recent forecast (of December 2013), the OeNB assumes a general government deficit (Maastricht definition) of 1.6% of GDP, which is well below the target of 2.3% of GDP.

At EUR 61 billion from January through October 2013, gross **federal tax** revenues topped the previous year's value by EUR 3.2 billion or 5.5%. As employment made strides and additional income generated by wage taxes resulting from bracket creep (5.6% until October 2013 year on year), the revenues generated by other income and revenue taxes have also increased strongly (e.g. corporate income tax in the first 10 months of 2013: +11.3% against the same period of 2012). With demand low, transaction and excise tax revenues rose only little (+1.6% until October 2013 year on year).

Contributions to unemployment insurance and contributions to the **Family Burden Equalisation Fund** are expected to deliver **more revenue** than budgeted. Also, the rise in **social security contributions** in 2013 was roughly on a par with that in 2012, as employment is still expanding. Consequently, the statutory health insurance funds will generate a surplus in 2013, as they did in 2012 (Main Association of Austrian Social Security Institutions: about EUR 160 million).

As to **fiscal expenditures**, Austria's budget execution is strict. Personnel and administrative expenditures are likely to correspond to the amount in the budget estimate. Federal government employees received zero wage increases in 2013. Pension increases in nominal terms amounted to a moderate 1.8% in 2013 (inflation rate from January to October 2013: 2.1%). With the number of unemployed persons augmenting in 2013, unemployment benefit expenditure also augmented.

The **debt ratio** is assumed to rise moderately again in 2013 despite the deficit reduction, the repayment of **participation capital** (EUR 1.4 billion) as a result of debt-increasing payments (such as EUR 890 million of equity for the European Stability Mechanism, ESM, and EUR 1.2 billion for lending by the European Financial Stability Facility, EFSF). According to the "**Draft Budgetary Plan of Austria for 2014**," which the **interim federal government** delivered to the EU in October 2013, Austrian debt is expected to reach **74.6% of GDP** at the end of 2013.

Excursus Austrian Bank Support Package

2013 was the sixth year in a row in which the government had to implement measures to stabilize the banking sector on the basis of the Austrian Financial Market Stability Act. The Fiscal Advisory Council assumes that the total burden on the **budget according to ESA95** (capital transfers, current expenditure, current revenue) will sum up to EUR 2.0 billion. This overall value breaks down into the following components:

- Nationalized banks will require further aid. The transfers provided for in the budget, EUR 950 million (EUR 700 million for Hypo Alpe Adria Bank, EUR 250 million for KA Finanz AG) are anticipated to rise by about EUR 1 billion to EUR 1.95 billion.

- Current income from guarantee fees will continue to contract in 2013 as a result of the sharp reduction (estimate for 2013: around EUR 120 million) in guarantees provided. The dividend payments for participation capital issued come to just under EUR 300 million.

- The additional debt incurred for capital transfers increased current expenditure (estimate for 2013: EUR 320 million) in the form of costs to finance this debt.

If this increase in borrowing is offset by repayments of participation capital by Erste Bank AG (EUR 1.2 billion) and BAWAG bank (EUR 200 million), measures taken under the Financial Stability Act lead to a rise of nearly EUR 450 million in **government debt** in 2013. All measures taken under the Financial Market Stability Act since 2008 have resulted in a cumulated deficit of EUR 6.2 billion and have increased debt by EUR 9.1 billion (including participation capital).

As the restructuring of Hypo Alpe Adria Bank is still outstanding, further measures are expected in 2014. The impact of as yet undecided restructuring measures on the debt and deficit cannot be estimated. It is certain, however, that bank support will increase Austria's budget deficit and debt in 2014.

Not Enough Consolidation Has Been Achieved to Meet Medium-Term Budgetary Objectives

According to the Austrian Draft Budgetary Plan of October 2013 and the Austrian Stability Program for 2012 to 2017 of April 2013, the **general government budget deficit** is to come to **1.5% of GDP in 2014.** However, the Fiscal Advisory Council anticipates that the deficit **may be higher** because there will be no high revenue windfalls as in 2013 and because additional transfers to banks might become necessary. The anticipated lack of income from the financial transaction tax in 2014 will be offset by revenues generated by the tax agreement with Liechtenstein.

The **structural budget deficit** (cyclically adjusted budgetary position net of one-off and other temporary measures) is expected to trend downward. Austria is expected to meet the **medium-term budgetary objective** (MTO; a structural deficit not exceeding 0.5% of GDP) decided by the EU and enshrined in the fiscal compact for the first time in 2016 as officially provided for in the Austrian stability program for 2012 to 2017. Moreover, the Austrian Stability Pact 2012 mandates a structural deficit limit of 0.45% of GDP from 2017. The structural budget balance figures could be subject to strong fluctuation. The **European Commission's figures** must be used to evaluate whether budget performance meets the EU standards. According to the November 2013 forecast of the European Commission, Austria's structural budget deficit will stand at 1.6% of GDP in 2013 and at 1.5% of GDP in 2014.

Official national and European Commission forecasts predict that a decline in the debt ratio will trigger a **trend reversal in debt growth** from **2014**. Assuming comparatively sound economic growth with annual GDP growth of 4% and a small budget deficit of 1% of GDP a year from 2014 (average deficit ratio of the past 20 years: 2.6% of GDP per annum), the debt ratio of 74% of GDP at the end of 2013 would contract to **62% of GDP** by 2020 exclusive of one-off factors (stock-flow adjustments such as loans or equity investments). However, for Austria, the new European accounting framework that will become effective in 2014 (**ESA 2010**) will result in a permanent increase in the debt ratio. Statistics Austria currently estimates that the debt ratio will rise by 2.5% of GDP under the new framework.

As things stand, overall, Austria will **not fully comply with** the EU's **fiscal rules** in 2014.

EU Rules Prescribe Strict Fiscal Consolidation

Since 2009, Austria has been subject to an **excessive deficit procedure** (EDP) and is thus obliged to comply with the following conditions:

- reduction of the deficit ratio to below 3% of GDP by 2013
- an average annual (structural) fiscal effort of 0.75% of GDP from 2011 to 2013
- a declining debt ratio

Based on the European Commission's opinion of November 2013 on Austria's draft budgetary plan, the abrogation of the EDP appears within the realms of possibility: In addition to the sustainable **correction of the general government deficit** to below the 3% of GDP threshold, Austria made **sufficient progress with the structural fiscal balance** from 2011 to 2013.[1] The abrogation of the EDP procedure will depend on the final **restructuring of Hypo Alpe Adria Bank**, whose impact on the deficit and on debt will only become fully clear once the form of restructuring has been decided.

If the EDP is abrogated, Austria will be **subject to the preventive arm** of the Stability and Growth Pact (SGP) in **2014**.[2] Compliance with the preventive arm means the following (unless special provisions apply in the case e.g. of natural disasters or a severe economic downturn):

- An **annual improvement of the structural balance of more than 0.5% of GDP** is required as long as the MTO has not been achieved and as long as the debt ratio exceeds the reference value of 60% of GDP. Starting from a structural budget deficit of around 1.5% of GDP in 2013, Austria should **reach the MTO by 2015**. The Council of the European Union determined the deadline for achieving the MTO in its country-specific recommendations in June 2013.
- Annual (real-term) **government expenditure growth is to be limited to the reference medium-term rate of potential GDP growth** unless the excess is matched by discretionary revenue measures. As long as Austria does not reach its MTO, it must reduce expenditure growth more strongly. For Austria, this adjustment comes to about 1 percentage point
- The **general government debt ratio must be reduced at a rate** so that the **difference to the reference value of 60% of GDP diminishes by an average of 5% a year over the previous three years (years t-1 to t-3)** or on the basis of the European Commission forecast ("no-policy-change" assumption, in the year just ended, current and next year (years t-1, t and t+1). After an EDP procedure has been abrogated, the country is still under observation during a **transition period of three years** after the correction of the deficit, at the end of which compliance with the debt rule is judged.

For Austria, the **strict application of EU fiscal rules** in 2014 means the following:

- Austria will not fully comply with the required structural adjustment in 2014 on the basis of the latest figures of the European Commission (of November 2013): According to the European Commission, the structural balance will remain nearly unchanged from 2013 at -1.5% of GDP.
- In the draft budgetary plan of October 2013, the annual real-term expenditure increase is below the reference average medium-term rate of potential GDP growth of 0.1%; according to the opinion of the European Commission, it is above the reference rate, however. Analyses of the Austrian Federal Ministry of Finance pin the discrepancy between the values to divergent interpretations of concepts ("revenue increases mandated by law") and differing assumptions about the cost of support to nationalized banks. The European Commission is expected to

[1] The structural adjustment during the period from 2011 to 2013 came to an average of 0.8% of GDP per annum according to the European Commission ("effective action").

[2] If the EDP procedure against Austria is not abrogated, the deadlines for required structural adjustments are to be extended or further EDP steps are to be taken in line with Article 126(7) of the Treaty.

provide an in-depth analysis on this issue.

- The extent of the debt ratio reduction from 2014 complies with the provisions of the debt rule for the three-year transition period.

To sum it up, the European Commission concluded that Austria's draft budgetary plan was **broadly compliant with the rules of the SGP**. The Commission, however, invited the authorities to **ensure full compliance with the SGP** within the national budgetary process for the 2014 budget and to submit an updated draft budgetary plan as soon as the new government has taken office.

Overall Assessment: Sustainability of Austrian Public Finances Must Be Underpinned by Structural Reforms

In the **view of the Fiscal Advisory Council**, implementation of the **scheduled consolidation course in line with the stability program for 2012 to 2017** requires more detailed commitment and a strict implementation of the foreseen measures. In any event, additional sustainable consolidation measures will definitely be required to reduce the **structural budget deficit** by more than 0.5% in 2014 year on year, to **reach the medium-term budgetary objective (MTO)**, namely a structural budget deficit of no more than 0.5% of GDP **by 2015,** and to **comply with EU fiscal rules in the next years** (the "sixpack").

It is the view of the Fiscal Advisory Council that consolidation brought about by structural measures with a permanent impact while at the same time stepping up proactive measures would be possible and desirable from an economic perspective. There is room for maneuver to sustainably dampen public expenditure in 2015 at the latest (e.g. by reducing multiple financial support, simplifying administration, resolving conflicts of responsibility between different levels of government, exploiting the potential to make health care, urban transport and similar areas more efficient, and by strengthening cooperation above all at the social services and local levels. In the best case, such a **bundle of measures** on the expenditure side could start to have an effect already in 2014, cover the currently calculated medium-term permanent fiscal consolidation needs and create scope to relieve the tax burden on labor in the medium term. The changed economic and socioeconomic framework has made additional expenditure necessary, e.g. in the areas education, child care, environmental protection, science and research. These additional expenditures will have to be financed at least partly by structural reforms in other areas. In addition, a tax reform should encompass **structural reforms** that promote growth and relieve the tax burden on labor.

The **economic recovery** expected from 2014 will moderately increase the room for fiscal maneuver. Ceteris paribus, additional real growth of 1% of GDP reduces the budget deficit by an amount of the order of 0.5% of GDP (or about EUR 1.6 billion), above all because government revenues are higher. Any rise in **potential output** (the sustained average growth rate under normal utilization of production factors inputs) in Austria would additionally help moderately improve the structural budget balance, which is an important analytical indicator.

Performance budgeting (wirkungsorientierte Verwaltungssteuerung) at the federal level and outcome-orientated impact assessment under this framework has the potential to identify considerable efficiency potentials in federal government measures. In this respect, the Fiscal Advisory Council recommends that the existing model at the federal level be further evolved and made legally binding at the provincial and local level in a simplified form, in particular to draw up operational targets and to elaborate methodically advanced impact assessment methods.

The room for **fiscal maneuver in the medium to long term** is expected to be restricted by additional expenditure on **pensions, long-term care and health care** triggered by the changing demographic structure, so that there will be need for action here in the next few years as well. In its meeting of October 2013, the Austrian **Commission for the Long-term Sustainability of the Pension System** determined that on the basis of the projections available, considerable additional federal expenditure on the state pension scheme are to be expected in the medium to long term (the maximum burden is projected to come to about 6% of GDP in 2049 compared to 2.8% of GDP currently). Expenditure on civil servants' pensions is anticipated to drop from 3.5% of GDP in 2011 to about 1.4% of GDP in 2050 (long-term budget forecast under Article 15(2) Federal Budget Act 2013). Therefore, measures to ensure the long-term viability of the pension system will be required. Clarifying the measures to be taken with regard to pensions and health care in due time will not only strengthen the credibility of a sustainable, stable budget policy in Austria but will also allow Austrians to adapt to changed conditions. Unless structural measures are taken over the medium term to rein in expenditure linked to demographic change, important expenditures to strengthen Austria's growth potential, such as investment in research and development and in infrastructure, will come under pressure.