REPORT ON AUSTRIA'S COMPLIANCE WITH EU FISCAL RULES

This report evaluates the update of the federal government's **Austrian Stability Programme** for the period 2013 to 2018 as at April 2014. It focuses on **monitoring compliance with the multiple EU fiscal rules** in place for the **general government** (central, regional and local governments as well as social security funds as defined in the European System of Accounts – ESA).

The **Austrian economy** has recovered more quickly from the deep international financial crisis than the euro area as a whole. By 2013, Austria's real GDP growth was slightly above the pre-crisis level of 2008; the structural budget deficit has declined, and prices are stable. While employment is increasing, however, unemployment is going up yet again, and the economy has spare capacity. The current account surplus is expected to come to 3.3% of GDP in 2014 (WIFO forecast, March 2014).

The Fiscal Advisory Council expects the **excessive deficit procedure (EDP)** against Austria to be abrogated by mid-2014, even if the deficit threshold of 3% of GDP is temporarily exceeded when factoring in the restructuring of Hypo Alpe-Adria-Bank via an asset resolution vehicle. Although Austria's deficit ratio is low by international comparison (2013: –1.5% of GDP), **Austria's fiscal path** laid down in the Stability Programme (table 1) for the period from 2014 to 2018 **does not fulfill all EU requirements**.

Table 1: EU Fiscal Rules as Applied to Austria (2013–2018)[1)]

General government budget, total	Corrective arm		Preventive arm[2)]				
	2013	Ø 2011–2013	2014	2015	2016	2017	2018
Deficit (Maastricht definition): below threshold of 3% of GDP	**YES**	**YES**	**YES**	**YES**	**YES**	**YES**	**YES**
General government budget deficit (% of GDP)	-1,5	-2,2	-2,7	-1,4	-0,7	-0,6	-0,5
Structural adjustment of deficit ratio: objective achieved[3)]	**YES**	**YES**	**NO**	**NO**	**YES**	**–**	**–**
Objectives for structural adjustment (percentage points):	–	0,75	> 0,5	> 0,5	–	0	0
Implemented and/or planned structural adjustment (in percentage points)[4)]	1,4	1,0	0,1	0,3	0,4	0,0	0,1
Structural balance (% of GDP)[3)]	**-1,3**	**-1,8**	**-1,2**	**-0,9**	**-0,5**	**-0,4**	**-0,3**
Government expenditure growth: objective achieved[3)]	**YES**	**–**	**NO**	**YES**	**YES**	**–**	**–**
Permissible real expenditure growth (change in %)[5)]	0,3	–	0,3	0,3	0,3	–	–
Implemented and/or planned real expenditure growth (change in %)[6)]	-1,8	–	0,8	-4,4	-2,2	–	–
Reduction of debt ratio: one of three objectives achieved	**–**	**–**	**YES**	**YES**	**YES**	**–**	**–**
Austrian public sector debt (% of GDP)	74,5	–	79,2	77,6	75,6	73,4	71,5

1) Authors' calculations based on the fiscal path according to the updated Stability Programme and WIFO forecasts, as at March 2014.
2) In 2016, the objective will be reduced to comprise the adjustment necessary to reach the MTO. The MTO is to be reached by 2017.
3) Deviations from Federal Ministry of Finance figures owing to diverging output gap assumptions.
4) Change in the structural balance including correction factors in the corrective arm (i.a. revisions of potential growth).
5) Average potential growth rate less a certain percentage (haircut) as long as the MTO has not been reached.
6) Spending aggregate i.a. excluding interest payments or spending on unemployment benefits; discretionary income is considered.
Source: Austrian Institute of Economic Research (WIFO), March and February 2014 forecasts; Federal Ministry of Finance (April 2014 Stability Programme) and authors' calculations.

The Austrian budget's structural adjustment path and the growth of expenditure in line with the expenditure rule reflect consolidation efforts which – under the assumed economic framework conditions – would have to be more ambitious. According to the updated Stability Programme, Austria is set to reach the medium-term objective (MTO) of a **structurally balanced budget** only in 2016. This means that the reduction of the structural budget deficit according to the Stability Programme is slower than required under the adjustment path. Meanwhile, the federal government has announced further measures intended to avoid any substantial deviations from the structural adjustment path.[1]

According to the Fiscal Advisory Council, **structural reforms changing the distribution of tasks** and the definition of **distinct interfaces** between federal, regional and local authorities (i.a. in the fields of **health care, long-term care, subsidies** and **education**) are required to ensure **sustainable compliance** with the balanced budget rule.

In November 2013, the **European Commission** concluded that Austria's draft budgetary plan was broadly compliant with EU rules. It recommended, however, that Austria should try to reach its **structural MTO by 2015**.

Rule-Based EU Fiscal Policy Strengthened to Ensure Budgetary Discipline

The **EU's fiscal rules** were expanded against the background of the financial, economic and sovereign debt crisis; implemented at the national level in Austria via the 2012 Austrian Stability Pact, they **define ceilings** for the general government regarding

- the size of the **budget deficit**,
- the path and size of the **structural budget deficit**,
- the path of **real-term** general government **expenditure** and
- the path and level of general **government debt**.

Noncompliance with the fiscal rules (ex post assessment of t-1 as part of the European Commission's spring forecast) will result in **sanctions**. An excessive deficit procedure (EDP) under the corrective arm of the Stability and Growth Pact (SGP) will only be initiated if the **Maastricht criteria** are violated (i.e. if the deficit threshold of 3% of GDP is permanently exceeded or if the debt ratio is above 60% and no sufficient corrections are taken). The fiscal rules on the path and size of the **structural budget balance** (= cyclically adjusted budget balance less one-off measures) reflect the economic goals of EU fiscal policy. Once the MTO of a structural budget deficit of no more than 0.5% of GDP is reached, maintaining this level should contribute to a **cyclically adequate, countercyclical orientation of fiscal policy** in the Member States, which used to be the exception in the past. Failure to comply with the structural requirements or with the expenditure rule does not trigger an EDP. However, if deemed necessary, i.e. if there are substantial deviations from the defined fiscal path, **early warning mechanisms** will be triggered (e.g. a set of EU measures with deadlines, an automatically triggered correction mechanism at the national level, opinions by the fiscal advisory councils, etc.) to strengthen budgetary discipline in the Member States and to avoid a violation of the Maastricht criteria. **Austria** defined its general government budget MTO as a **structural budget deficit of 0.45% of GDP**.

Given the continuous revision of underlying data, however, calculations of the structural budget balance produce results that are fraught with considerable uncertainties. Additional uncertainties result from different calculation and forecasting methods as well as from the fact that potential output cannot be determined precisely. This explains deviations in the results produced by different institutions (WIFO, European Commission, IMF, OECD).

1 A "substantial deviation" of the structural fiscal path from the specified adjustment path would trigger the early warning mechanism, entailing EU recommendations and an obligatory time schedule for corrective measures.

Abrogation of Austria's Excessive Deficit Procedure Expected for Mid-2014

Since December 2009, Austria has been subject to an EDP according to Article 126 (6) of the Treaty on the Functioning of the European Union (TFEU) , which comprised the following recommendations:

- reduction of the general government deficit ratio to below 3% of GDP by 2013,
- reduction of the structural general government deficit by an average of 0.75% of GDP per annum for the years from 2011 to 2013,
- declining debt ratio.

Based on the European Commission's spring forecast, the EU Council will decide in June 2014 whether to abrogate the EDP against Austria. From the point of view of the Fiscal Advisory Council, an **abrogation of the EDP** against Austria is to be expected for the following two reasons:

- Austria's **general government deficit ratio was reduced** to below 3% of GPD already **in 2011** and has remained below that threshold ever since, coming to no more than 1.5% of GDP in 2013. Even if the restructuring of Hypo Alpe-Adria-Bank via an asset resolution vehicle is taken into account, the 3% threshold is not expected to be exceeded substantially or permanently.
- Austria complies with the debt criterion relevant for EDP abrogation since its **debt ratio is expected to decline in line with the debt rule** from 2014 onward. Moreover, funding extended to stabilize the financial markets ("relevant factors") may be taken into account when assessing compliance with the debt rule.

According to recent information, the European Commission is also likely to support an abrogation of Austria's EDP.

Austria Does Not Comply with All EU Fiscal Rules as of 2014[2)]

In the following, we assume that the **fiscal rules of the preventive arm** of the SGP will apply to Austria as of 2014. Basically, these rules contain the following requirements:

- The **structural budget balance** is to be **adjusted by more than 0.5% of GDP** per annum as long as the MTO has not been achieved and as long as the debt ratio exceeds the reference value of 60% of GDP.
- Annual (real-term) **government expenditure growth** is to be **limited** to the reference medium-term rate of potential output growth (less a haircut) unless the excess is matched by discretionary revenue measures.
- The **government debt ratio** is to be **reduced** in line with the debt rule. Following EDP abrogation, the country in question remains under observation for a **three-year transition period**, at the end of which compliance with the debt rule must be ensured.

The Austrian federal government aims to reach its general government budget MTO of a maximum structural budget deficit of 0.45% of GDP in 2016. The adjustment path toward this MTO corresponds

2 Deviations from calculations by the Federal Ministry of Finance are due to diverging output gap assumptions.

to an average reduction of the structural deficit ratio by 0.3 percentage points per annum and is therefore **not in line with the requirements of the preventive arm** of the SGP (as of 2014: >0.5% of GDP). Structural adjustment is expected to deviate from requirements in **2014 and 2015. Strict compliance** with the structural budget rule would enable Austria to reach the MTO **as early as 2015**.

The **expenditure rule** relates to factors which tend to be within the control of political decision-makers (governments, national assemblies, regional parliaments, etc.). Any assessment of compliance with the expenditure rule should be based on the growth rate of an **(adapted) real expenditure aggregate** (primary spending excluding expenditure for unemployment benefits and less discretionary revenues) which is aligned with average medium-term **potential GDP growth**. For the period from 2014 to 2016, the **growth ceiling** for the **real-term expenditure aggregate in line with the expenditure rule** is 0.3% per annum. Considering the target values of the updated Stability Programme and WIFO macroresults, the Fiscal Advisory Council is of the opinion that Austria complies with the expenditure rule for the observation period from 2013 to 2018 (with the exception of 2014). The annual growth rates of the real expenditure aggregate, however, are strongly influenced by one-off effects. For example, Austria's failure to comply with the expenditure rule in 2014 is basically explicable by the 2013 base effect (receipts from the sale of mobile phone licenses were recorded as expenditure-reducing; deductible taxes were raised) and by expenses related to the restructuring of Hypo Alpe-Adria-Bank.

According to the updated Stability Programme, Austria's general government debt ratio is to be reduced gradually from its peak at end-2014 (79.2% of GDP) to 71.5% of GDP in 2018 (i.e. the end of the period covered in the Stability Programme). If the EPD against Austria is abrogated in the course of 2014, the reduction of the debt ratio toward the reference value of 60% of GDP will have to be assessed on the basis of the **debt rule during a transition period** for 2014 to 2016. For this three-year transition period, the **linear structural minimum adjustment** of the **budget balance** serves as a reference value for compliance with the debt rule.[3] According to the federal government's current objectives, the reduction of Austria's structural budget deficit for this period is in line with requirements. This means that Austria **complies with the debt rule during a transition period.**

Currently available data on regional and local government budgets are not sufficient to assess compliance with these multiple fiscal rules at the subsectoral or regional level in line with the 2012 Austrian Stability Pact. Such an assessment would, above all, require quantitative information on revenue- and expenditure-side measures as well as ESA-compliant data on the expenditure paths in the individual provinces (regional and local breakdown).

Government Program Fails to Specify Major Structural Reform Plans

Apart from the individual budget consolidation measures quantified in the 2014 Stability Programme, the **government program** primarily envisages the following **four essential reform priorities** without substantiating or quantifying them, however:

- **Establishing a task and deregulation commission** to increase efficiency in public administration. The distribution and fulfillment of central, regional and local government tasks and responsibilities is to be reviewed;
- Increasing efficiency by **eliminating the duplication of tasks and responsibilities across central, regional and local governments**;
- **Reforming the fiscal sharing system**, i.a. by disentangling joint tasks and mixed funding, and

3 This structural minimum adjustment is necessary for Austria to meet the future-oriented debt benchmark at the end of the transition period (2016).

introducing task-adequate funding;

- **Implementing structural tax reform**, i.a. by simplifying the tax system (e.g. reducing the initial rate to close to 25% while at the same time flattening progression).

These unresolved issues primarily require **fundamental policy decisions**; therefore, they must be addressed at the highest political level. Establishing working groups, as currently envisaged, seems to be useful as soon as political consensus has been reached on the way forward. Before tax cuts can be implemented, the government must create the necessary budgetary leeway.

Discretionary Measures Characterize Fiscal Consolidation Path

The current general government fiscal path according to the April 2014 Stability Programme comprises several sets of measures ("2011 Loipersdorf Package", "Stability Package 2012–2016" as well as the 2014 Tax Code Amendment Act) the **federal government** adopted since 2011. Their political objective was to produce a **higher consolidation volume** on the **expenditure side** than on the revenue side. According to present calculations, the **discretionary consolidation volume on the expenditure side** (net, offsetting investment measures) produced since 2011 accounted for around 40% of total consolidation in 2014 and is expected to account for around 55% by 2018. Looking at the observation period from 2013 to 2018, the total annual volume of these measures (net) is expected to amount to at least EUR 5.2 billion (1.7% of GDP) in 2013 and grow to up to EUR 10.1 billion (2.8% of GDP) in 2017. These figures reflect the fact that progress toward consolidation on the revenue side (e.g. by adjusting tax rates) is possible on a relatively short-term basis, while cuts in spending (e.g. administrative reforms) often have longer lead times. When factoring in the **additional consolidation effects** of "bracket creep" and interest savings, the contribution of expenditure- and revenue-side measures will be 50% each in 2018. The central government's latest consolidation efforts of early 2014 consisted mostly of revenue-side measures.

The estimated savings in the **pension systems, in administration and health care** appear to be particularly **uncertain**. Expenditure for **long-term care**, in particular, appears to be growing fast. Finally, it cannot be excluded that additional expenditures will be necessary in the **banking sector**. Problems in these areas might endanger the achievement of objectives by 2018.

Official central government data were used as the basis for calculating the effect of the consolidation measures. Only measures that were implemented according to schedule or that are just being implemented were taken into account. Revenues from a financial transaction tax for the observation period from 2013 to 2018 were not taken into account, for example, and the Federal Ministry of Finance's estimations of savings volumes were adjusted in some cases (subsidies, administration costs).

Lack of Explanations and Quantifications Makes Budget Path Difficult to Assess

While the **federal government's updated Stability Programme** basically covers the range of information on the **general government balance** required by the EU, it contains hardly any explanations on the contents of tables or clear indications of the respective data sources. This circumstance allowed only a **rudimentary plausibility check** of budgetary developments.

Currently available **data** on regional and local government budgets **are not sufficient** to assess compliance with the multiple fiscal rules at the subsectoral or regional level in line with the 2012 Austrian Stability Pact (national fiscal rules). Such an assessment would, at least, require quantitative information on revenue- and expenditure-side measures as well as ESA-compliant data on the expenditure paths in the individual provinces (regional and local breakdown).

Fiscal Advisory Council Received Legal Mandate in November 2013

The Austrian **Fiscal Advisory Council** is entrusted with **monitoring Austria's compliance with EU fiscal rules**. It is the successor to the Government Debt Committee and was established by means of an amendment "on the establishment of the Fiscal Advisory Council" (Fiskalratgesetz, Federal Law Gazette No. 149/2013) in early November 2013. The establishment of the Fiscal Advisory Council is in line with an obligation in force since November 2013 that requires all euro area countries to establish independent **bodies for monitoring compliance with fiscal rules at the national level** in order to intensify the monitoring of draft budgetary plans (Regulation (EU) No 473/2013). This measure serves to ensure that individual Member States adhere to and comply with EU fiscal rules more closely than before. The Fiscal Advisory Council was also entrusted with all the tasks previously performed by the Government Debt Committee (e.g. fiscal policy recommendations, fiscal policy analyses and studies, contributions to the public debate).