REPORT ON AUSTRIA´S COMPLIANCE WITH EU FISCAL RULES (MAY 2015)

This report evaluates **the federal government's fiscal targets** according to **the stability program for the period 2014 to 2019**. In particular, it focuses on **monitoring compliance with the multiple EU fiscal rules** in place for the **general government** budget (central, regional and local governments as well as social security funds as defined in the European System of Accounts). To gain an even more concise picture of Austria's fiscal situation, the Fiscal Advisory Council produced a **fiscal forecast**, which covers the years **2015 and 2016**. Together with the figures provided in the federal government's stability program, the results of the forecast are used to analyze Austria's compliance with the EU fiscal rules.

The **Austrian economy** is currently growing at a weak pace; the stability program and the European Commission's outlook put real GDP growth in 2015 at 0.5% and 0.8%, respectively. Neither **domestic demand** (contribution to growth according to the stability program: +0.6; European Commission: +0.7) nor **net exports** (contribution to growth according to the stability program: –0.1; European Commission: +0.1) are likely to revive noticeably. Owing to the corporate sector's subdued expectations, investment activity remains cautious, offsetting positive stimuli from the international environment such as lower oil prices, the depreciation of the euro and the ECB's asset purchase program. Both the stability program and the European Commission see a recovery of the Austrian economy only in 2016, with real GDP growth reaching 1.4% and 1.5%, respectively.

Table 1: EU fiscal rules as applied to Austria

General government	European Commission 2014	Fiscal Advisory Council estimate 2014[1]	2015	2016 Scenario 1	2016 Scenario 2	Federal Ministry of Finance estimate (stability program) 2014	2015	2016
Maastricht deficit of no more than 3% of GDP	✓	✓	✓	✓	✓	✓	✓	✓
Medium-term objective (incl. margin of tolerance)[2]	✓	✓	✓	⊗	⊗	✓	✓	✓
Structural adjustment of deficit ratio[3]	✓	⊗	⊗	⊗	⊗	✓	⊗	⊗
Government expenditure growth[4]	.	⊗	⊗	⊗	✓	⊗	⊗	✓
Reduction of debt ratio	✓	✓	✓	⊗	⊗	✓	✓	✓
Austrian general government fiscal indicators (% of GDP)								
Budget balance (Maastricht definition)	-2,4	-2,4	-1,8	-2,1	-1,6	-2,4	-2,2	-1,6
Structural budget balance	-0,4	-0,6	-0,6	-1,6	-1,0	-0,3	-0,5	-0,5
Total expenditure (real, adjusted, change in %)	.	3,1	-0,3	1,8	0,5	3,1	0,2	0,4
Gross debt (year-end figures)	84,5	84,5	86,2	85,5	84,9	84,5	86,8	85,7

Note: ✓ ... fiscal rule has been met, ⊗ ... fiscal rule has not been met, ⊗ ... fiscal rule has not been met and significant deviation[5]

1) A more optimistic economic scenario would result in a structural budget balance of –0.5% of GDP for 2014.

2) If Austria reaches the medium-term objective (MTO) of –0.45% of GDP, noncompliance with structural adjustments of the deficit ratio or the expenditure rule will not trigger procedural steps.

3) Reduction of the structural deficit subject to macroeconomic conditions, the level of the debt ratio and the remaining need for adjustment to reach the MTO.

4) Average medium-term potential growth rate less a certain percentage (convergence margin) as long as the MTO has not been reached.

5) A deviation is deemed significant if the structural deficit deviates at least by 0.5% of GDP from the structural adjustment path or the MTO within one year or cumulated over two years; a deviation from the debt rule during the transition period is deemed significant if the structural adjustment deviates from the required minimum linear structural adjustment (MLSA) by more than 0.25% of GDP.

Source: Federal Ministry of Finance (stability program of April 2015), WIFO (March 2015 outlook), European Commission (May 2015 outlook) and Fiscal Advisory Council's calculations.

The **federal government's fiscal targets** (as set out in the stability program 2014 to 2019) envisage a reduction of the **budget deficit (Maastricht definition)** in 2015 and 2016. This reduction is to be achieved essentially on the back of improving economic conditions and the expiry of measures that had triggered one-off effects weighing on the budget balance (e.g. bank aid measures); no substantial impact can be expected from structural consolidation measures. The **federal government expects a structural budget balance** of around 0.5% of GDP in the years 2015 to 2018.

Key results

The **Fiscal Advisory Council** considers that the federal government's fiscal consolidation plans as outlined in the stability program in combination with the envisaged stimulus measures will not suffice to ensure compliance with the EU fiscal rules in the coming years, even though Austria achieved a **low structural deficit ratio in 2014** (0.4% of GDP according to the European Commission; 0.3% of GDP according to the stability program; 0.6% of GDP according to the Fiscal Advisory Council's calculations; see table 1). There is some uncertainty with regard to the effects of the resolution of Hypo Alpe Adria Bank AG on the budget balance.

The **spring forecast of the Fiscal Advisory Council** expects the **structural budget deficit** to amount to 0.6% of GDP **in 2015**, thus remaining at 2014 levels but also **within the margin of tolerance** of +0.25% of GDP from the **medium-term budgetary objective**(MTO) of 0.45% of GDP. Noncompliance with the expenditure rule in 2015 will not trigger procedural steps under the Stability and Growth Pact because Austria's structural budget deficit is within the allowed range.

The fiscal forecast of the Fiscal Advisory Council presents a **more pessimistic** picture for **2016**. The **2015/2016 tax reform** could **jeopardize** the fiscal course the federal government had envisaged. The Fiscal Advisory Council has carried out its calculations using two different sets of assumptions on how the tax relief measures scheduled for 2015/2016 will be funded: Under **scenario 1**, which is based on the European Commission's assumptions made in its spring outlook 2015 (resources from fighting tax fraud are expected to generate half the amount of additional revenues envisaged by the federal government and expenditure cuts are also expected to have a smaller impact), the Maastricht budget deficit will climb from 1.8% of GDP in 2015 to 2.1% of GDP in 2016, and the structural budget deficit will widen from 0.6% of GDP (2015) to 1.6% of GDP (2016). **Scenario 2**, which is based on the legislative proposals of May 2015 underlying the tax reform, assumes that the envisaged additional revenues and expenditure cuts materialize in full and have the planned budgetary impact. Under this scenario, the Maastricht budget deficit will decline to 1.6% of GDP, while the structural budget deficit will still increase notably (+0.4 percentage points to 1.0% of GDP).

Under both scenarios, it seems likely that **in spring 2017** the **early warning mechanism under the preventive arm of the Stability and Growth Pact will trigger a significant deviation procedure**. Likewise, it cannot be completely ruled out that an **excessive deficit procedure** will be launched due to noncompliance with the debt rule, unless additional measures are taken to fund the tax relief measures, if the impact of the measures scheduled does not materialize as planned.

The Fiscal Advisory Council's estimates suggest that a **significant deviation** (according to EU definition) from the **structural budget rule** in **2016** must be expected **under both scenarios**. Also, the **debt rule** will not be met in either scenario. A significant deviation from the debt rule must be expected only under scenario 1, however. Based on Fiscal Advisory Council's current assumptions, the expenditure rule will not be complied with in 2016 under scenario 1, but will be met under scenario 2. A minor increase in expenditure in 2016 would already cause a significant deviation from this rule under scenario 1.

The Fiscal Advisory Council and the federal government's stability program use **recent data on economic activity** provided by the WIFO outlook of March 2015. In addition, the Fiscal Advisory Council conducted its **evaluation of the application of the EU fiscal rules to Austria** on the basis of its own fiscal forecast and used its own output gap estimate, which follows the same methodological approach as the European Commission's estimate and which is lower than WIFO's figure, which was used in the stability program.

In view of the weak – medium-term – economic outlook and the increasing costs associated with an aging society, enhancing efficiency in the pension and health care systems and cutting related expendi-

ture should be a key priority. Also, the federal government must remain committed to its plans of reforming the tasks and responsibilities of central, regional and local authorities (disentangling joint tasks, mixed funding and transfers of funds). The Fiscal Advisory Council's forecast identifies a **disproportionately high rise of spending** compared with aggregate spending, above all when it comes to unemployment benefits, pensions and health care benefits-in-kind.

Fiscal rule compliance in detail

Deficit clearly below Maastricht benchmark (3% of GDP) – reduction of the deficit may be delayed by 2016 tax reform

The **spring forecast of the Fiscal Advisory Council** expects Austria's general government deficit ratio to decline to 1.8% of GDP in 2015, from 2.4% of GDP in 2014. Essentially, this decline reflects lower spending needs following the establishment of HETA, a winddown facility for Hypo Alpe Adria AG, in 2014. Like the current stability program, the Fiscal Advisory Council's forecast anticipates lower spending needs in support of ailing banks (table 11). However, the actual size of the budgetary effects that may result from the measures taken to wind down Hypo Alpe Adria Bank AG is subject to uncertainty. If the compensatory measures adopted to fund the 2015/2016 tax relief measures fail to become fully effective in 2016 **(scenario 1)**, the general government deficit is likely to bounce back to 2.1% of GDP in **2016**. Under **scenario 2** (compensatory measures take full effect) the deficit ratio is expected to continue to drop, to 1.6% of GDP. In **both scenarios,** the budget deficits are markedly below the upper threshold of 3% of GDP; thus Austria stands to **clearly meet the Maastricht budget rule over the entire forecasting horizon**.

The **fiscal targets** outlined by the **federal government** (stability program for the period 2014–2019) are also in line with the Maastricht budget rule. However, **compared with** the spring forecast of the Fiscal Advisory Council, the **stability program** foresees a smaller decline in the general government deficit for 2015 (2014: 2.4% of GDP; 2015: 2.2% of GDP). At the same time, the stability program forecasts Austria's deficit to improve by 0.6 percentage points in 2016, to 1.6% of GDP, despite the tax reform. The improvements of the deficit (Maastricht definition) anticipated for 2015 and 2016 are driven above all by a decline in capital transfers (one-off measures in support of banks) as well as an amelioration of the economic environment.

Noncompliance with the structural budget rule over the forecasting horizon – significant deviations as defined by the EU in 2016

The results for potential output as **calculated by the Fiscal Advisory Council** in line with European Commission methods (based on the latest macroeconomic forecast of WIFO) match the European Commission's definition of "normal" economic times for both 2015 and 2016 (table 13). Against this backdrop, the budget forecast of the Fiscal Advisory Council expects Austria's **structural budget deficit** to amount to 0.6% of GDP **in 2015**, thus remaining at 2014 levels but also **within the margin of tolerance** of 0.25% of GDP from the **medium-term budgetary objective** (MTO) of –0.45% of GDP. In contrast, the forecast for **2016** is that of **a sizeable increase of the structural budget deficit**, namely to 1.6% of GDP (scenario 1) or 1.0% of GDP (scenario 2). The higher structural deficit under scenario 1 reflects above all the assumption that 2016 will bring a net tax relief and that compensatory measures on the expenditure side (administrative reform, cuts in subsidies) will not fully materialize. Moreover, the forecast reflects the impact of cyclical aspects, which is more pronounced under scenario 2 in particular.

Unlike the budget plan of the federal government, the **spring forecast of the Fiscal Advisory Council** identifies **noncompliance with the structural adjustment requirements** of the preventive arm of the Stability and Growth Pact in both 2015 and 2016, amounting to a **significant** deviation (as defined by the EU) under both scenarios **in 2016.** A significant deviation in 2016 triggers an ex post in-depth review by the European Commission in spring 2017. If the European Commission also finds evidence of a significant deviation from the spending rule in its ex post assessment, it will, as a next step, launch a **significant deviation procedure**.

In contrast, the **federal government** expects to have **met the MTO in 2014** and to arrive at a slight, virtually steady deviation from the MTO of –0.45% of GDP in 2015 and 2016. This assessment is based on two assumptions: first that the compensatory measures adopted to fund the 2015/2016 tax relief measures will broadly materialize; and second that there is a high degree of slack in the economy, since the negative output gap as measured by WIFO significantly exceeds the corresponding estimates of the Fiscal Advisory Council and the European Commission.

The **Fiscal Advisory Council's spring forecast expects social expenditure to remain the key driver of public spending growth, as adjusted** for one-off measures, in **2015 and 2016**. The Fiscal Advisory Council's forecast identifies a **disproportionately high rise of spending** compared with adjusted aggregate spending, above all when it comes to unemployment benefits, pensions and health care benefits-in-kind, on account of the weaker economy and proactive measures among other things. Despite the reforms that have been implemented in the area of health care and pensions, related spending continues to rise at a faster pace than nominal GDP.

Additional spending significantly exceeds upper threshold in 2015

The spring forecast of the Fiscal Advisory Council foresees average annual **real growth** of (adjusted) **public spending** by 1.0% (scenario 1) or 0.4% (scenario 2) in the period from 2014 to 2016. However, these relatively low averages (geometric mean) are subject to a downward bias, as the measures adopted to **restructure Hypo Alpe Adria AG** resulted in a one-off increase of baseline spending (2014) by EUR 3.8 billion. Adjusted for this special effect, real public spending (adjusted) increases by 2.2% (scenario 1) or 1.6% (scenario 2) on average per year. [1]

In the case of Austria, the following **upper thresholds** apply for **additional real aggregate spending**: +0.8% in 2015 and +0.9% in 2016. Since the establishment of a winddown vehicle for Hypo Alpe Adria AG (HETA) eliminated the need to provide extra capital for the bank in **2015**, real spending drops by 0.3% in 2015 compared with 2014, enabling Austria to clearly **undershoot the threshold of 0.8%** (**one-year assessment**). At the same time, a real rise in combined average spending in 2014 and 2015 (**two-year assessment**) of 1.4% leads to a **significant deviation from the benchmark** in 2015.

In **2016,** the drop in net revenues resulting from the tax reform will cause an annual increase in (adjusted) aggregate spending by 1.8% **(scenario 1)**, well beyond the acceptable increase in spending of 0.9%. Also, an increase by 1.8% is only slightly below what would qualify as a significant deviation. **Scenario 2** yields a 0.5% increase in spending, well below the acceptable growth rate, given larger spending cuts to fund the tax reform and a lower drop in revenues.

Regarding 2015, noncompliance with the spending rule does not trigger any procedures under the Stability and Growth Pact, as the MTO is within the margin of tolerance. Regarding 2016, the results of **scenario 1**, given the narrow result for the spending rule, imply the risk that the **alert mechanism (significant deviation procedure)** might be triggered immediately – without any preceding procedures – **in**

1 The average annual growth rates of adjusted real aggregate spending are characterized by special effects, as the application of the spending rule does not provide for adjustment for one-off measures.

spring 2017. The results of **scenario 2**, in particular noncompliance with the structural budget rule, imply that the European Commission is likely to perform an **in-depth review**. The alert mechanism is triggered when the Council of the European Union finds evidence of noncompliance with the Stability and Growth Pact.

In **comparison**, the **federal government** expects significant deviations, based on the spending rule, to be limited to the year 2014.

Noncompliance with debt rule because of insufficient minimum structural adjustment in 2016

Meeting the forward-looking debt benchmark under the **debt rule** in the **transition period** (2014 to 2016) requires a **minimum adjustment of the structural budget balance** of –0.1% of GDP in the first year and of –0.3% of GDP per year over the remaining period. In other words, Austria could suffer a slight deterioration of the structural budget balance during this period without violating the debt rule.

Regarding 2015, the **spring forecast of the Fiscal Advisory Council** expects the **structural budget deficit** to remain at the level of 2014, thus meeting the required minimum adjustment. Regarding **2016,** the marked increase of the structural deficit ratio by 1.0 percentage point (scenario 1) or 0.4 percentage points (scenario 2) means that Austria will **fail to meet the required minimum adjustment** under both scenarios. **Scenario 1** even implies **a significant deviation**, as defined by the EU, from the debt rule **in 2016**. If the European Commission were to confirm a significant deviation from the benchmark in its ex post assessment in spring 2017, this would by definition trigger an **excessive deficit procedure** and a report from the Commission under Article 126(3) TFEU.

In **contrast,** the debt path outlined by the current **stability program** is in line with the debt rule over the entire transition period, up to the end of 2016.

Evaluation of budget developments difficult as explanations and quantifications are missing

While broadly meeting the EU's information requirements for the **general government**, the **current stability program of the federal government** does not provide any details on the underlying assumptions regarding the effects of the **discretionary measures** (in particular with regard to the 2015/2016 tax reform), **very little explanation** on the scope covered by the **tables,** and **no clear indication of the respective data sources**. These limitations allowed only for a **rudimentary plausibility check** of the finance ministry's budget estimates for the general government.

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

The mandate of the Fiscal Advisory Council (since November 2013)

The **Fiscal Advisory Council for Austria** is entrusted with **monitoring Austria's compliance with EU fiscal rules**. It is the successor to the Government Debt Committee and was established in early November 2013 (Fiscal Advisory Act, Federal Law Gazette No. 149/2013). The creation 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 at the national level to strengthen the monitoring of compliance with fiscal rules**. 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 has also been 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).