Current Fiscal Performance and Recommendations by the Fiscal Advisory Council on Austria's Budget Policy and Budget Financing in 2015

Adopted at the Fiscal Advisory Council meeting on December 10, 2014

Subdued Economic Outlook for 2015

In its World Economic Outlook of fall 2014, the IMF continues to expect a slight recovery of global economic activity in 2015, with real GDP growing by 3.8% in 2015 after 3.3% in 2014, even though downward risks, especially those resulting from geopolitical tensions, have increased substantially since the spring outlook. The European Commission expects economic momentum to remain weak, with growth in the **euro area** accelerating only marginally to 1.1% in 2015 (2014: 0.8%). The recovery in the euro area has been hampered by the repercussions of the economic and financial crisis – above all high private and public debt levels, high unemployment – and by delays in structural and institutional reforms. The short period of deflation seen in a few euro area countries in 2014 should not be continued on the basis of current forecasts for 2015.

In **Austria**, the economy is also slow to recover as export demand has remained weak and domestic demand is only moderate. The September 2014 outlook of the Institute of Economic Research (WIFO) predicts real GDP to expand moderately (2014: +0.8%; 2015: +1.2%). The outlooks of the OeNB, the European Commission and the OECD published in November and December 2014 broadly confirm these expectations. More recent forecasts, however, assume that growth will be lower in 2014 (between +0.4% and +0.7%). For 2015, the OeNB, the European Commission and the OECD anticipate real GDP growth between 0.7% and 1.2% (year on year).

Despite an environment of very low interest rates, domestic investment will remain muted in 2015 because of weak sales prospects. Consumer spending is set to expand moderately in 2015 as the real disposable income of households will start to pick up again after stagnating in 2014. As a result, consumer spending continues to be the most important demand component in terms of its contribution to growth, even if it remains at a low level. The international environment, above all geopolitical tensions (e.g. the crisis in Ukraine), energy prices and exchange rates, represent uncertainties that may impact economic activity in Austria.

The **labor market situation in Austria** is not expected to improve in 2015 as the economy is operating below capacity and labor supply is rising (especially because of the influx of labor from abroad). In the year to date, the number of unemployed persons increased markedly (+32,400 year on year between January and October 2014), while employment growth (+23,600 over the same period) lost momentum. This trend is set to continue in 2015, albeit at a lesser pace. Both payroll employment and the number of registered unemployed persons will increase by about 20,000 in 2015, according to the WIFO outlook. Against this background, Austria's unemployment rate (Eurostat definition, i.e. the ratio of unemployed persons to the labor force) is expected to rise from 4.9% in 2013 to over 5% in 2015. The national unemployment rate (the ratio of unemployed persons to payroll employment) will climb to almost 9% in 2015 (2014: 8.4%) according to WIFO.

Austria's Current Fiscal Performance Better than Anticipated

Based on the WIFO outlook of September 2014, the **Fiscal Advisory Council** predicts in its outlook that the **general government deficit (Maastricht definition)** will be 2.5% and 1.4% of GDP in 2014 and 2015, respectively. These deficit ratios are clearly below the **targets set out in the federal government's Draft Budgetary Plan (DBP)** – 2.8% of GDP for 2014 and 1.9% of GDP for 2015 – which were published in mid-October, based on the same economic conditions. The Fiscal Advisory Council's outlook assumes a **deficit-increasing effect of measures implemented under the bank support package** of 1.2% of GDP for 2014 (2015: 0.2% of GDP), comprising, in particular, the establishment of the Hypo Alpe-Adria-Bank wind-down vehicle.

General government revenues are expected to rise by **3.2%** and **2.9%** (year on year) in **2014** and **2015**, respectively. The expected slowdown in the rise of government revenues from 2014 to 2015 is attributable to discretionary measures that went into force mainly in 2014 (including a raise in a number of excise taxes, the motor vehicle tax and the bank tax as well as a rising number of voluntary disclosures of evaded taxes due to new rules). At 3.1% per year, average revenue growth over these two years will be slightly below the long-term average of 3.4% (the average annual growth rate over the past 15 years). **Revenues from indirect taxes** are expected to expand by 2.8% each in 2014 and 2015, revenues from **direct taxes** are predicted to increase by 5.8% and 3.8% in 2014 and 2015, respectively (in total: +4.2% for 2014, +3.3% for 2015). More than half of the increase in revenues from direct taxes over the forecast horizon will be traceable to wage taxes. At EUR 61 billion from January to October 2014, gross **federal tax revenues** were EUR 1.9 billion or 3.1% higher than in the same period of the previous year.

According to the outlook of the Fiscal Advisory Council, government revenues will total some EUR 165 billion or 49.8% of GDP in 2014. Compared with the federal government's DBP (submitted on October 15, 2014), general government **revenues** as projected by the Fiscal Advisory Council are lower by EUR 0.4 billion or 0.1% of GDP and by EUR 0.2 billion or 0.1% of GDP in 2014 and 2015, respectively.

The Fiscal Advisory Council expects general government **expenditure** to rise by 5.2% and 0.8% year on year in 2014 and 2015, respectively. The marked expenditure rise in 2014, which will flatten substantially in 2015, is attributable to **one-off effects** (EUR 4.2 billion in capital transfers under the bank support package; in addition, the proceeds from the LTE mobile spectrum auction which were recorded as negative expenditure of EUR 2 billion in 2013 are no longer taken into account). Adjusted for one-off effects, total government expenditure growth in 2014 and 2015 will be fairly stable and comparable to previous years (2014: +2.6%, 2015: +2.7%). The federal government is continuing its policy of **moderate fiscal consolidation** on the expenditure side.

Apart from one-off measures, **social benefits other than social transfers in kind** and **compensation of employees in the public sector** are the main expenditure categories. Following a wage freeze in 2013, public sector employees have negotiated a wage increase by 1.4% plus EUR 14.5 for 2014 and a raise equaling the inflation rate (1.8% according to the WIFO outlook) for 2015. The increase in pensions in nominal terms amounted to 1.6% in 2014 (inflation rate from August 2012 to July 2013: 2.4% less 0.8 percentage points). The rise in the number of unemployed persons and total compensation of employees generates additional spending for unemployment benefits (2014: +12%, 2015: +7.4%).

General government expenditure will come to EUR 173.4 billion or 52.5% of GDP in 2014, according to the Fiscal Advisory Council, thereby remaining 0.4% and 0.5% of GDP below the path depicted in the DBP for 2014 and 2015, respectively.

Austria's public debt (Maastricht definition) is expected to increase sharply in 2014, reaching 85.8% of GDP at year-end (end-2013: 81.2% of GDP). This rise by 4.5 percentage points is attributable to a general government deficit of 2.5% of GDP and stock-flow adjustments of 4.0% of GDP (especially due to the bank support package, EU assistance facilities and period accruals). The denominator effect of GDP growth reduces the debt ratio by 1.9 and 2.4 percentage points in 2014 and 2015, respectively. While the transfer of liabilities after the establishment of the **Hypo Alpe-Adria-Bank wind-down vehicle** in 2014 will increase government debt by EUR 17.8 billion, the repayment of government participation capital (by Raiffeisen Bank International AG and BAWAG PSK AG) totaling EUR 2.1 billion and the ongoing winding down of assets of KA Finanz (EUR 0.5 billion) will reduce government debt. On the basis of the Federal Ministry of Finance's data referring to the stock-flow adjustments under the bank support package, the Fiscal Advisory Council expects the debt ratio to decrease by 1.5 percentage points to 84.3% of GDP in 2015.

Austria Can Reach Medium-Term Fiscal Target in 2015

Under the given assumptions, the Fiscal Advisory Council expects the **structural budget deficit** to improve by **0.6 and 0.2 percentage points in 2014 and 2015**, respectively, from 1.3% of GDP in 2013.

Austria could therefore achieve its medium-term objective (MTO) of an almost balanced structural budget of –0.5% of GDP already in 2015. According to the Fiscal Advisory Council's projections, Austria's general government debt is expected to stand at just below 86% of GDP at end-2014, and to decline in 2015. Accordingly, **Austria would, in essence, fulfill the EU fiscal rules in 2014 and 2015**, with the exception of the expenditure benchmark, which will not be met due to one-off effects like the establishment of the Hypo Alpe-Adria-Bank wind-down vehicle. The **possibilities** for taking measures that would raise the deficit, such as economic stimuli through increased spending or reducing the tax-to-GDP ratio, remain **very small**.

The Fiscal Advisory Council considers the **federal government's Draft Budgetary Plan 2015** to be plausible but cautious, given the underlying macroeconomic assumptions. The differences between the government's budgetary plan and the more favorable outlook of the Fiscal Advisory Council concerning the budget balance and the structural budget balance are 0.3% of GDP (2014) and 0.5% of GDP (2015). However, despite the additional measures pledged by the federal government at the end of October 2014, the **European Commission** continues to see the **danger of a "significant deviation"** from the structural adjustment path toward the medium-term objective in 2015 (according to the Commission 2014 fall outlook, the structural budget deficit will be 1.1% of GDP and 1.0% of GDP in 2014 and 2015, respectively).

When **interpreting** the results in relation to the **EU's numerical fiscal rules,** estimation uncertainties concerning the underlying data, in particular **potential output** and the **structural budget balance**, must be taken into account. For instance, in cases where the numerical results are close to the EU's thresholds, data revisions may lead to different assessments regarding compliance or noncompliance with the rules.

Long-Term Compliance with Fiscal Rules Requires Government to Constantly Adjust Policies

To achieve an almost balanced budget over the business cycle for many years, all decision-makers in Austria (government authorities, employer and employee representatives, associa-

tions, etc.) must be guided by the objective of achieving macroeconomic stability while maintaining the sustainability of public finances, and of the existing social security systems in particular. A constantly changing environment requires continuous reform efforts geared at the most effective and efficient use of limited public funds. One of the priorities should be to reassess the existing system of how the federal, regional and local governments use their resources as well as the organization of the federal distribution of tasks (e.g. evaluating the impact on growth and employment, evaluating the size and distribution of subsidies and the efficiency of public administration).

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 and population growth, so that there will be need for action in these areas in the next few years as well. Reforms that have already been launched must be further pursued with determination. Delaying reforms may generate huge economic and social costs and trigger procyclical effects.

Core Elements of the Tax Reform Need to Be Determined Soon

To avoid further uncertainties, the government should soon agree on the core elements of the planned tax reform in Austria, which is supposed to reduce the high taxes and charges on labor. The fragile economic situation in Europe and geopolitical risks are weighing on the investment climate. In addition, uncertainties regarding the future structure of tax and social security contributions are dampening private demand and negatively affecting Austria's attractiveness as a business location.

In any case, the planned tax reform will have to comply with the **EU fiscal rules** in the opinion of the Fiscal Advisory Council.

Raising the Efficiency of the Division of Responsibilities and Financial Relations between Central, Regional and Local Government

Inefficiencies in central, regional and local government structures need to be addressed in the course of the planned 2015/2016 reform of the fiscal sharing system by consolidating the responsibility for tasks, expenditure and financing of public services and seeing to a task-oriented funding – while taking into account the performance capacity of central, regional and local government. The fundamental principles and cornerstones of the reform should be agreed at the highest political level at the very beginning of the reform process.

The starting point should be a critical task analysis based on which it will be possible to conduct a reform of competencies and structures across the various levels of government (federalism reform). Such a reform should pursue the objective of consolidating the responsibility for tasks, expenditure and financing of public services, e.g. in the areas of **education, childcare, health, social affairs and agriculture**, and conferring this responsibility to either central, regional or local government authorities. On this basis, it would be possible to strengthen mechanisms that provide incentives for sound fiscal performance and efficient task fulfillment, to reduce the need for spending cuts and to implement simpler structures with fewer transfers of funds between the different levels of government. Currently, the provinces have spending power, while their income is primarily determined by fiscal sharing and intergovernmental transfers.

Increasing Austria's Growth Potential through National Reforms and Participation in European Growth and Employment Initiatives

Despite its fiscal constraints, Austria should provide funding for investment- and growth-

enhancing measures in all – central, regional and local – government budgets by re-allocating funds; in addition, the government should make use of the EU funds earmarked for the European Fund for Strategic Investment and improve the national regulatory framework for private investment. It would be advisable for government to invest in e.g. R&D, infrastructure and in increasing human capital. Public investment may boost, but cannot replace private investment and innovation.

For the planned **investment initiative** at the **European level**, parts of the EU budget would need to be used differently both at EU and national level according to a recent communication by the European Commission. The main idea is for the public sector to take over part of the risk of investment projects, thereby creating **incentives for private investment in profitable projects** which would otherwise not be realized (e.g. in connection with the promotion of R&D, energy efficiency as well as information and communication technology). **Risk-sharing between the public and the private sector** needs to be balanced.

Compliance with EU Governance and Transparency Requirements Needs to Be Ensured

Draft Budgetary Plans should be complemented with mandatory continuous, strategic financial management and the application of harmonized and accrual-based accounting rules at the regional and local levels. Related results or noncompliance should be reported to the coordinating body of the Austrian Stability Pact, which has to publish the reported facts. The fragmentation and heterogeneity of the public sector has increased considerably owing to the policy of outsourcing government tasks, which has been extensively pursued at the central, regional and local levels – these extra-budgetary entities already account for around 20% of public expenditure. This has rendered the financial management of central, regional and local government authorities more complex and obscure. This phenomenon will be more adequately and transparently captured thanks to the transition to the ESA 2010 (previously: ESA 1995 – European System of Accounts). Budgetary slippages in the wake of the financial crisis have shown the need for reforms of the budget system and the management of equity interests.

The transition toward outcome and impact orientation (which results are to be achieved with tax revenues) triggered by the **2013 Federal Budget Act**, as well as direct responsibility and transparency at the federal level should be deepened. Also, legal provisions at the regional and local levels should be adjusted to a budget system that is compatible with the federal model.