FISCUL RULES COMPLIANCE REPORT 2018–2023 FOR AUSTRIA (MAY 2019) – SUMMARY AND RECOMMENDATIONS

The Fiscal Advisory Council's "**Fiscal rules compliance report for 2018 to 2023**" analyzes the medium-term fiscal path implied by the latest update of Austria's stability programme (Federal Ministry of Finance, 2019), monitors Austria's compliance with EU-wide fiscal rules and highlights critical issues with regard to Austria's national fiscal rules. This analysis builds on our own budget forecast for 2019 and 2020, which draws on information that was available by mid-May 2019, such as presentations made to the Council of Ministers and government bills released for public consultation. Unlike in the past, we had neither access to updated data from the Federal Medium-Term Expenditure Framework Act, nor were we able to use equivalent data. Given the **premature end of the 26th legislative session** and the upcoming reelection of parliament in September 2019, the **projected fiscal path** and **enactment of government-adopted measures are subject to a high degree of uncertainty.**

Continued robust GDP growth supports fiscal consolidation

WIFO's current economic outlook for the Austrian economy **expects a loss of momentum** yet **continued robust growth** over the medium term: Following growth of 2.7% in 2018, real GDP growth is expected to weaken visibly in 2019 (to 1.7%) and to keep decelerating until 2023 (to 1.4%) (Medium-term economic outlook of WIFO, March 2019). According to our estimates, the **output gap** turned positive in 2018 and **will remain positive from 2019 to 2022** but contract from 0.7% to 0.2%. The balance of **forecast risks** is **predominantly on the downside.** In the international context, there is the risk that trade tensions may escalate further or that the U.K. may leave the EU without a deal. In terms of domestic conditions, there is the risk that the investment cycle may turn out to be more volatile than expected.

Fiscal Advisory Council sees Austria in broad compliance with EU fiscal rules (based on spring 2019 forecast[1])

We expect Austria to achieve a general government budget surplus of 0.4% of GDP in both 2019 and 2020. The 0.3% improvement on the year for 2019 results from a marked **decline of the expenditure-to-GDP ratio, by 0.7 percentage points,** which is offset to some extent by a smaller **decline of revenues as a share of GDP (–0.3%)**. The decline of the expenditure ratio will be driven above all by a moderate growth of monetary social benefits and a further decline of interest payments. With regard to **2020, the budget balance is expected to change only marginally,** even though revenues from social security contributions are expected to shrink visibly and spending on gross investment is expected to rise visibly. However, these changes will be compensated for by the growth rate of monetary social benefits, intermediate consumption below the nominal GDP rate and shrinking interest payments.

We expect **Austria's structural budget balance to improve to +0.1% of GDP in 2019,** which corresponds to an improvement by 0.5 percentage points. Furthermore, this implies that the structural deficit will improve at a faster pace than the budget balance, as the positive output gap is expected to narrow, which, in turn, entails a reduction in the cyclical component of the budget balance. Since we expect the structural primary balance to improve in the presence of a positive output gap, this means that the **fiscal policy stance will be slightly countercyclical and contractionary,** following a broadly neutral stance in 2017 and 2018. For **2020,** we expect the structural budget balance to remain broadly unchanged at **0.1%** of GDP. In other words, we expect the **stance of fiscal policy to be almost neutral**.

We consider **Austria** to **clearly achieve its medium-term budgetary objective (MTO)** (maximum structural deficit of 0.5% of GDP) over the forecast horizon. Since 2015, some EU countries have been allowed to temporarily depart from the adjustment path to the MTO given **the impact of unusual events**

1 This analysis is based on the baseline scenario of the report.

on the financial position (assistance provided to refugees and spending on counter terrorism measures). Following the decline of these costs over time, this aspect is set to play only a minor role in Austria over the forecast horizon.

We project **revenue growth** to reach **3.1% in 2019** and **2.8% in 2020**. This means that revenue growth will be considerably lower than in 2018 (+4.8%) and also below nominal GDP growth (2019: +3.8%, 2020: +3.7%). As a result, we expect revenue as a share of GDP (national definition) to go down from 48.6% (2018) to 48.3% (2019) and 47.9% (2020). Likewise, we expect the tax ratio (national definition) to go down from 42.2% (2018) to 42.1% (2019) and to 41.8% (2020). The lesser momentum of revenue growth can be traced back to the **cooling of the economy** and to revenue-reducing measures, above all **higher tax relief for families with children** from 2019 and **lower health insurance contributions for lower-income employees** from 2020.

Lower expenditure growth in 2019 (2.4%) than in 2018 (2.9%) is driven above all by a sharp decline in **interest payments** given the low interest rate environment and the fact that **transfer payments to the EU,** which turned out to be unexpectedly high in 2018, will revert to normal levels in in 2019. At the same time, a marked increase in **pension costs** and high **wage settlements** for public sector employees compared with 2018 are having an offsetting effect. **Stronger expenditure growth forecast for 2020** (2.9%) is based on expectations of markedly higher **gross investment** in the areas of healthcare (lifting of the cap on social security spending), railway infrastructure and defense (planned purchase of military vehicles) and a slower decline of interest payments.

Based on our spring forecast, we expect Austria to **fail to comply with the expenditure rule in 2019** (average deviation over two years). From today's perspective this is, however, **unlikely** to trigger the European Commission's **alert mechanism.** After all, Austria stands to achieve its MTO and may expect the European Commission to ease its requirements for 2019 even further in its final ex post evaluation in spring 2020 in view of the presumed MTO compliance in 2018.

Having been able to **pay down (gross) general government debt** since 2016, Austria is set to continue to reduce debt in 2019 and 2020 due to **high primary surpluses** and the **shrinking indebtedness of nationalized banks** as well still **declining interest payments**. The **marked decline of the debt-to-GDP ratio to 69.6% and 66.4%** reflects not only the decline of gross debt but also **strong GDP growth** and **low financing costs**. We find Austria's general government **debt path** to be **clearly in compliance with the EU debt rule.**

Stability programme update 2019 sees Austria in broad compliance with EU fiscal rules

As outlined in the stability programme update for 2018–2023 from April 2019, Austria's **medium-term fiscal path** (general government, Maastricht definition) aims to bring the **debt-to-GDP ratio below 60% by 2023,** despite the **slight GDP decline** and the introduction of **higher tax relief for families** and the **2019/20 tax reform**. According to the current fiscal path, Austria is expected to achieve a general government budget surplus (Maastricht definition) of 0.3% in 2019, and to achieve further small surpluses in the two following years (0.2% of GDP in 2020 and 2021) and balanced budgets thereafter (0.0% of GDP in 2022 and 2023). Moreover, Austria is expected to achieve a **balanced structural deficit** from 2021 onward, following consistent reductions of the deficit in the run-up to 2021. The **MTO** was **reached in 2018** and is expected to be achieved throughout the time horizon of the stability programme update. Based on the **current fiscal path**, Austria will remain broadly in **compliance with the EU-wide budget rules** (deficit rule, structural fiscal rules, debt rule) over the entire forecast horizon from **2018 to 2023**. Based on the stability programme update, Austria will **fail to comply only with the expenditure rule only in 2018 and 2019**, and only in **2019** will the deviation be **"significant"** (albeit just about) by the EU's definition (two-year average).

Compared with the stability programme update, **we forecast somewhat higher budget surpluses for 2019 and 2020** (+0.1% and +0.2% of GDP). On the revenue side, the biggest differences between the stability programme update and our forecast relate to higher social security contributions and higher direct and indirect taxes but lower investment income. The estimates of total revenues barely differ for 2019, but for 2020, we expect revenues to be 0.1% of GDP higher than the figure put forth by the finance ministry. On the expenditure side, we forecast lower expenditure on monetary social benefits and subsidies, but higher spending on employee compensation and investment than the stability programme update. In sum, we forecast total expenditure in 2019 and 2020 to lie 0.1% below the figures forecast by the finance ministry.

Some regional and municipal governments may fail to comply with national fiscal rules (structural balance rules, debt rule) from 2019 onward

Based on the subsectoral Maastricht balances for 2018 as notified to the EU in March 2019, Austria will **comply** with the structural balance rules **in sum at the municipal and regional level** but **fail to comply with those rules at the central government level.** At the same time, the central government's shortfall continues to remain significantly below the threshold that would trigger sanctions, even taking into account the control account balance for 2017. Moreover, the stability programme expects the central government's control account balance to turn positive in 2019. While at the time of the March notification, the regional aggregates of the municipal results were not yet available, it was expected that individual municipal and regional governments have also failed to comply with the requirements for a balanced structural budget in 2018 (for instance Styria and Vorarlberg). This perception is reinforced for the **subsequent years** by the currently available medium-term fiscal plan from fall 2018. Regarding the **agreement reached to reduce the government debt ratio,** Styria, Vorarlberg, Tirol and Vienna are expected to have missed the targets under Austria's 2012 Fiscal Stability Pact in 2018, and judging from the medium-term fiscal plans, they will continue to do so in the **years ahead**.

To conclude, judging from the **control account balances for 2018**, we **do not expect sanctions** to be imposed under article 19 of Austria's Fiscal Stability Pact of 2012. This assessment is based on the fact that the municipal governments have clearly improved their fiscal positions when we compare the data included in the medium-term fiscal plans from fall 2018 with the fiscal positions notified in March 2019. **From 2019 onward,** however, the medium-term fiscal plan shows above all municipal governments to exceed the thresholds that would trigger cyclically appropriate reductions of government debt as well as sanctions under Austria's 2012 Fiscal Stability Pact. Yet the data for 2018 also show that meaningful analyses presuppose **accurate estimates of the current and medium-term fiscal paths** as well as **timely data on fiscal developments** on all subsectoral levels.

Conclusions and recommendations of the Fiscal Advisory Council

Based on the considerations and analyses presented in this Fiscal rules compliance report for 2018 to 2023, the Fiscal Advisory Council issues the following financial policy recommendations to the different levels of government in Austria:

The effects of automatic stabilizers need to be able to freely unfold and the medium-term budget objective needs to be persistently pursued

Background: According to the Fiscal Advisory Council's current spring forecast, Austria's fiscal stance for 2019 is slightly contractionary, i.e. countercyclical and designed to have a stabilizing macroeconomic effect; for 2020, it will be mostly neutral. Austria is expected to clearly fulfill its MTO over the entire forecast horizon.

Recommendations:

- Austrian policymakers should continue to pursue a **stability-oriented budget policy** that will enable Austria to sustainably **fulfill its medium-term budget objective** (–0.5% of GDP). This requires **countercyclical fiscal policies** aimed at achieving budget surpluses in economically good times (positive output gap) and budget overspending in economically bad times (negative output gap).

- In view of the upcoming parliamentary elections in September 2019, we reiterate our recommendation of December 2018, emphasizing that **complex, major reform projects** – in particular reforms which can be expected to have financial implications for households and businesses and may affect their behavior – should be made subject to **strict impact-oriented criteria under the Federal Budget Act**. Such criteria may include:

  - taking into account the **complex fiscal and economic effects of tax and transfer reforms** (interaction between taxes and transfers, incentive effects) by applying tried and tested **models** (micro simulation models, macro models, combined models);

  - ensuring the **verifiability and transparency of cost estimates** and **assumptions** of the

    - estimates of direct and indirect fiscal effects (increases in costs, savings) and macroeconomic effects,

    - estimations of staff and administrative costs, and the

    - costs incurred until the reform has become fully effective;

  - providing **scenarios** that illustrate the upside and downside risks to the cost estimate (ranges);

  - providing mandatory **cost estimate evaluations by independent external bodies for reforms of a certain scale** (to be specified);

  - taking appropriate measures to ensure that bills put forward through **parliamentary motions** are also subjected to a high-quality impact assessment process.

Implementing structural reforms to ensure sustainable public finances

Background: Given the **premature end of the 26th legislative session** and the upcoming reelection of parliament in September 2019, **reform activities** in the public sector are unlikely in the foreseeable future. However, in terms of macroeconomic conditions, there is currently a window of opportunity for implementing structural reforms: Public finances are benefiting from strong economic tailwinds, persistently low market interest rates and budgetary leeway that has opened up on the back of consolidation measures and the most recent boom phase and since some extraordinary expenditure items are no longer necessary (e.g. banking package).

Recommendation:

- Policymakers should take advantage of the **favorable conditions** to **implement structural reforms** designed to safeguard the **long-term sustainability of public finances**. Priority should be given to reforming the competencies of the different levels of government and structural reform projects including sustainable financing models in age-related areas of expenditure (healthcare, long-term care, pensions, education).

- Once a new federal government has been formed, it needs to **quickly outline its fiscal policy** (in the form of a Federal Finance Act and the Federal Medium-Term Expenditure Framework Act), which needs to pursue stability objectives and support macroeconomic development.

- With a view to enhancing strategic budget planning at the federal government level and strengthening the role of parliament (Nationalrat) in the budgeting process, both a **comprehensive debate of the federal government's fiscal strategy** and the **discussion and adoption of strategic and economic policy objectives** should take place in the spring (with the latter including, e.g., the central government Maastricht budget balance, the overall fiscal stance taking into account economic developments, economic policy priorities, sustainability). In this context, **strategic** and **economic policy objectives should be quantified in budget terms** and the **budgetary impact** of the planned budget path as well as possible **scenarios** should be made transparent.

Prioritizing investments in infrastructure and human capital to gradually raise the quality of public finances

Background: Shifting budgetary funds toward innovation, investments, education and employment raises the quality of public finances and should at the same time contribute to their long-term sustainability, but also to higher economic growth and employment. To illustrate this point: the share of total gross fixed capital formation and social benefits in kind in the education sector in Austria's general government expenditure has been stagnating, standing at 6.5% in 2019. Moreover, public infrastructure investments are mostly subject to government discretion and may be reprioritized in the face of short-term consolidation needs (as evidenced by postponed investments in ÖBB infrastructure (Austrian Federal Railways) in the context of the federal government's biennial budget for 2018/19).

Recommendations:

- Policymakers should aim to raise the **quality of public finances** by proactively focusing on investment expenditure, in particular on **infrastructure investments** but also on investments to create **human capital**.

- Against this background, policymakers should prioritize the implementation of **investment plans** that are likely to have a **broad policy impact** (especially macroeconomic, social and environmental effects), and **realign expenditure**.

Increasing the incentive effects of the Austrian tax and transfer system

Background: Isolated tax law measures may result in inconsistencies in the overall system and cause conflicting effects.

Recommendations:

- The interplay of income tax, social security contributions (e.g. health insurance contributions) and the design of unemployment benefits, assistance to the long-term jobless and means-tested minimum benefits and other social transfers that differ across regions should ensure **unambiguous work incentives** (tax bracket leaps or local effective marginal tax rates of 100% and higher etc. should be avoided).

- The **incentive effects of the tax system** should be strengthened and increasingly used to address a broad set of objectives. For example, restructuring taxation by strengthening ecological elements could reduce the comparatively high tax burden on labor and at the same time have desired ecological and fiscal side effects (reducing emissions and avoiding financial penalties if CO_2 thresholds are breached).

- Policymakers need to take into account the **entire tax and transfer system** when developing the **Austrian tax system**, e.g. when indexing income tax brackets to inflation to eliminate bracket creep. This could help avoid inconsistencies that would arise from partial measures.

Improving the national fiscal rules framework and monitoring system to facilitate effective central steering

Background: As part of the multidimensional fiscal rule system under Austria's 2012 Fiscal Stability Pact, Austria introduced **control accounts** in early 2019. The purpose of these accounts is to highlight the amounts by which the realized structural budget balances of the central, regional and local governments may deviate from their annual targets. The **Fiscal Advisory Council** is entrusted with **monitoring conditions** and **issuing recommendations** that activate, extend or terminate the application of the automatic correction mechanism. This correction involves the necessary reduction of negative balances on the control accounts, which must be initiated once certain thresholds are breached. However, the **national fiscal rules framework** is very **complex** and the **data** on which the control account balances are currently based **have weaknesses** which will hamper forward-looking monitoring and effective central steering – as has been evidenced in an initial analysis of the control account balances of the different levels of government for the fiscal year 2018, in particular for the medium-term budget planning data of local and regional governments..

Recommendations:

- The addition of control accounts to the **multidimensional system of national fiscal rules** under Austria's 2012 Fiscal Stability Pact has made it possible to **refocus analysis**. This possibility should be used to reduce the complexity of the Fiscal Stability Pact, e.g. by simplifying the spending rule or by introducing a sequential application of the spending rule. This could, for instance, mean that the spending rule is only applied once a correction of control account deficits becomes necessary.

- **Timely information about budget developments** and **accurate medium-term budget plans** are crucial for making a realistic assessment of potentially adverse budget developments and associated breaches of fiscal rules, in particular at the level of regional and local governments.

- In our opinion, the threshold breaches in the control accounts of individual regional and local governments in the different Austrian provinces visible **from the year 2019** should be taken as an indication that policymakers need to ensure a strict **budget execution** in 2019 and **take timely countermeasures**. This should already be considered when updating the medium-term budget plans for 2019 to 2023.