

Recommendations of the Fiscal Advisory Council on Austria's budget policy

Adopted at the Fiscal Advisory Council meeting on December 1, 2017

Having discussed the **budget path in Austria from 2016 to 2018** at its latest meetings, the Fiscal Advisory Council presents the following **findings and recommendations**:

Austria's fiscal position temporarily improves in 2017 on the back of economic upswing; broad compliance with fiscal rules

Austria's **Maastricht deficit** is expected to **markedly contract**, to 0.7% of GDP, in 2017 (after 1.6% of GDP in 2016), the **Fiscal Advisory Council** says in its **fall forecast** (based on the WIFO's economic outlook of September 2017). **Government revenues** are set to increase by 3.8% or EUR 6.7 billion on the back of **buoyant economic activity** and the fact that **last year's one-off effect** triggered by wage and income tax cuts **is no longer an issue**. Also, government expenditure is growing relatively moderately, although a range of expansive budgetary measures (in particular to stimulate the labor market and investment activity) have been implemented; this moderate expansion is mostly due to small wage and pension hikes (2017: +1.9%).

Adjusted for positive fiscal effects triggered by the economic upswing (in particular higher tax revenues and less expenditure in connection with labor market developments), the **structural deficit (including eligible clauses, i.e. factoring out additional spending on assistance to refugees and counter-terrorism measures)** is expected to come to only 0.2% of GDP (2016: -0.5%). The **eligible clauses** resulted in deductions worth 0.4% of GDP for 2017, as allowed by the European Commission.¹

The **Fiscal Advisory Council** welcomes the **improvement in Austria's fiscal position in 2017**, which, according to its current forecast, is expected to ensure that after noncompliance in 2016, Austria will again be able to **broadly fulfill the various EU fiscal rules** in 2017. A sustained consolidation of public financing is currently not in sight, however. The **numerous economic policy measures** adopted by government toward end-2016 and in the 2017 election year will show their **full fiscal effects from 2018 onward** (causing the deficit to increase by EUR 1.0 billion or 0.3% of GDP in 2017, and by EUR 2.2 billion or 0.6% of GDP in 2018). These measures include, in particular, new subsidies for investment and the creation of new jobs (also for older long-term unemployed), a higher than usual increase in average pensions, the decoupling of long-term jobless benefits from partners' incomes and the abolition of public long-term care providers' recourse to patients' assets.

Strong economic upswing calls for neutral or restrictive fiscal stance in 2018

From a cyclical perspective, Austria's **fiscal stance** (i.e. the change in the structural primary balance ratio as a percentage of GDP in relation to the output gap) is **neutral in 2017** and – according to the **current fiscal outlook for 2018** – turning **procyclical** thereafter. Current estimates say that Austria is set to pursue an **expansive fiscal path in 2018**, even though for the first time since 2008, the domestic economy can be expected to be operating above normal capacity utilization levels.

Because of the **procyclical fiscal path that must be expected for 2018**, the European Commission, the Federal Ministry of Finance and the Fiscal Advisory Council predict Austria to record a Maastricht

¹ With regard to the structural budget balance and fiscal stance parameters it must be noted that the figures provided are analytical results that critically depend on the potential output, which, in turn, is typically subject to revision (even if past data are used).

deficit in 2018 despite benign economic conditions. According to the Fiscal Advisory Council, this deficit will amount to EUR 2.5 billion or 0.6% of GDP. In its **recommendations of May 2017** (executive summary of the Fiscal Rules Compliance Report 2016–2021), the Fiscal Advisory Council had called for new measures to be implemented only if their full funding was ensured and for legislative proposals to be adopted only on the basis of impact assessments to avoid “pre-election gifts.”

Factoring out cyclical effects but **including eligible clauses, the structural deficit is expected to considerably increase in 2018**, according to current Fiscal Advisory Council estimates, namely by 0.7% of GDP (2017: 0.2% of GDP). The eligible clauses total 0.3% of GDP in 2018.

Current forecasts point to **deviations from several rules** in 2018: The structural deficit will clearly exceed the medium-term objective (MTO) of –0.5% of GDP and the projected increase in government expenditure (2018: +4.4%) will clearly breach the ceiling as defined by the EU (2018: +2.6%), which will result in a **significant deviation from the expenditure rule**.

The **European Commission’s forecast** of November 2017 presents a **similar picture for 2018**, predicting the **Maastricht deficit** to reach 0.9% of GDP, a higher level than that calculated by the Fiscal Advisory Council (0.6% of GDP). As regards the structural budget balance, the European Commission and the Fiscal Advisory Council project the same values. In a **comparison** of budget balances for 2017 and 2018, Austria ranks in the **middle among the other euro area countries**.

Fulfilling the EU fiscal rules will become more difficult **from 2019 onward** as the **eligible clauses** (deductible additional costs in connection with refugee immigration and counter-terrorism measures) will – de facto – **cease to be applicable**. The allowances permitted from 2015 to 2018 will be **reduced** to a very low level (0.02% of GDP) in **2019** and will be **abolished altogether afterwards**.

The **Fiscal Advisory Council** calls for a **neutral to restrictive fiscal path** in 2018 given that **economic activity is expected to be robust**. It would be the right time, in particular, to amend legislation underpinning **economic stimulus projects** that currently entail substantial **deadweight losses, subsidies creating negative incentive effects** and/or other measures that may generate an **increasing fiscal burden in the medium to long term**.

Good conditions for curbing debt ratio

The **Fiscal Advisory Council** welcomes the **decline in the general government debt ratio** to be expected for **2017 and 2018**, which can be assumed to be substantial as the **economy is going strong, interest rates are very low** (negative interest rate/growth differential) and **debt-reducing effects in connection with the nationalized banks are expected to be particularly high**. The Fiscal Advisory Council projects the **general government debt ratio** to drop to 77.8% and 74.5% of GDP in 2017 and 2018, respectively, after 83.6% at end-2016. **Austria’s debt** is expected to slightly contract also in **nominal terms** (end-2018: EUR 288 billion; end-2016: EUR 295 billion).

Stock-flow adjustments² contributed substantially to the **decline** in government debt in **2017** (–EUR 9.8 billion). They are made up primarily of the **winding down of nationalized banks** (–EUR 6.5 billion) **and the reduction of high cash reserves** (–EUR 1.8 billion). In addition, they can be expected to include payments made by Bank Austria for **transferring accrued pension rights** under the bank’s internal pension scheme to the pension scheme under the General Social Security Act (ASVG) (–EUR 0.8 billion) and high **premiums** from over-par issues. In **2018**, debt-reducing stock-flow adjustments (–EUR 1.8 billion) will be mainly attributable to the ongoing **wind-down** of nationalized banks’ **assets** and **premiums** from over-par issues.

2 Changes in the debt level that cannot be attributed to net lending/borrowing (budget deficit or surplus).

The overall effect of government support to the financial sector (**banking package**) on Austria's **debt level** is expected to decrease from 10.9% of GDP 2016 to 9.5% and 7.3% of GDP 2017 and 2018, respectively.

The extremely **low level of nominal market interest rates** against the background of the **expansive monetary policy** seen in recent years have made it much easier to bring down high government debt levels across the EU. Austria's annual interest payments on government debt started to decline in 2012 (by an average EUR 300 million p.a.) even though government debt increased substantially owing to bank support measures.

The **Fiscal Advisory Council** advocates that the currently extraordinarily benign conditions (growth rate above interest rate level) be used for creating **fiscal leeway** and implementing **necessary structural reforms**. It is currently expected that gradual monetary policy normalization will begin in 2019 at the latest, which will be followed by a gradual increase in the interest rate level. While the impact of monetary policy normalization on **interest payments** on government debt (2018: EUR 6.2 billion according to Fiscal Advisory Council estimates) will be fairly small in the short term, a steady increase of payments will ensue, in particular owing to the rollover of government debt. A fictional 1 percentage point rise in the overall yield curve in 2017 and 2018 would result in additional interest spending in the amount of EUR 170 million (2018) and EUR 400 million (2019), respectively.

Reform of federal structures should be priority; efforts to boost structural reforms and investment in infrastructure should be intensified

The **Fiscal Advisory Council** recommends the federal government to take the necessary measures right at the **beginning of the new parliamentary term** to proceed with the preparations for a **reform of federal structures** in 2018 (as specified in the 2017 fiscal sharing agreement), including a review of tasks and responsibilities. The review should result in a **reform of competences and structures** that encompasses all levels of government and that should be guided by the objective of **full transparency and joint responsibility for public functions, spending and funding**. At present, regional governments (provinces) have spending power, but their revenues are determined largely by fiscal sharing and inter-governmental transfers. At the same time, the central government is obligated to provide funding to regional and local governments, often without having a say in the use of these funds.

The **Fiscal Advisory Council** recommends that the **federal and regional governments** review whether **structural reforms** are **eligible** for the flexibility provisions of the Stability and Growth Pact (SGP). Austria could launch a rule-consistent **structural reform plan** e.g. for **climate protection** or in **education** with initial extra budget spending, provided a **sustainable rise in potential growth** is to be anticipated (deviations from the rules are allowed for up to three years).

Furthermore, the Fiscal Advisory Council suggests that **planned government investments** be made earlier than scheduled (e.g. in broadband infrastructure and housing) and priority be given to **fighting social welfare and tax fraud** at the national and international levels.

Also, **more funds** should be provided for the **integration and education of asylum seekers and persons that have been granted asylum in Austria** to raise the economic potential of refugee immigration. For instance, special measures could be taken to promote apprenticeships in shortage occupations.

National fiscal rules to be tested for viability as Austria's Stability Pact entered full implementation in 2017

The Fiscal Advisory Council calls for a review and potential changes of the provisions of the Austrian Stability Pact (2012 ÖStP), their interpretation and the relevant calculation methods.

- By referring to the Stability and Growth Pact (SGP) or an analogous description of rules, the 2012 ÖStP essentially provides for the application of the **EU fiscal rules** to the regional and local government levels (regional breakdown, including divested public entities), which makes the **ÖStP**

considerably **more complex**.

- Practice has shown, however, that the **interpretation of national fiscal rules differs strongly in certain areas from the interpretation of EU rules**, apart from the fact that **the interpretation of the 2012 ÖStP** seems to be **controversial, in parts, among the contracting parties** (central, regional, local authorities).
- The 2012 ÖStP prescribes only an **ex-post assessment** of budgetary outcomes, which, as a rule, is made in the fall of the following year. The **European Commission**, in turn, assesses Austria's overall compliance with the EU's fiscal rules under the **European Semester** in the spring. This assessment includes both an **ex-post and an ex-ante assessment** of Austria's compliance with the EU's fiscal rules on the basis of the European Commission's spring forecast.
- The 2012 ÖStP does not provide guidance on the **role of the Fiscal Advisory Council** and the **interfaces** between the Fiscal Advisory Council and the other **entities involved in the assessment process as set out in the 2012 ÖStP** (Statistics Austria, Court of Audit, coordinating bodies). The Fiscal Advisory Council is charged with the timely monitoring of fiscal rules compliance and with observing **developments** that trigger, prolong or terminate the **correction mechanism** as set out in Article 7 Federal Law Gazette I No. 30/2013 and provide recommendations.

The **Fiscal Advisory Council therefore recommends** that the **2012 ÖStP** be replaced with **simpler and transparent rules and processes that are relevant for governance decisions** and that are in general compliance with **EU rules** in terms of materiality and time frame. In addition, it would be necessary to clarify the Fiscal Advisory Council's **adequate involvement as a watchdog**, and to ensure the **on-going transparency** of the **control accounts** to be maintained by the central and regional governments, as well as the transparency of rule **interpretation** and **operationalization**.

Long-time care costs might go beyond agreed cost containment path

The fiscal sharing agreement for 2017 to 2021 defines a **cost containment path for spending on long-term care for the elderly**, capping the increase in **gross spending at the regional and local government level** at EUR 4.5 billion (2021), up from EUR 3.6 billion (2016). However, according to projections of the Office of the Fiscal Advisory Council,³ local and regional government spending on long-term care will rise to up to EUR 5.2 billion in 2021 (depending on the underlying scenarios) in the absence of cost-cutting measures. This means that the **projected costs of long-term care** might be **higher** (by EUR 8 million to EUR 685 million) **than those permitted** under the cost-containment path. It must also be noted that this estimate does not include the fiscal effect of the **abolition of public long-term care providers' recourse to patients' assets**.

Long-term care falls under the responsibility of the **regional governments**, but is cofinanced across all levels of government. The **central government** currently contributes just over **one-half to public funding** (of long-term care for the elderly) (2016: share of central government 51%, share of regional and local governments 49%). Federal government: 49%). The projections expect the funding share of the regional and local governments to rise to at least 52% in 2021 (federal government: 48%).

Spending on in-home and institutional long-term care differs widely across Austria's provinces. The available public data explain the differences only to some extent (e.g. with regard to different staff-to-resident ratios in institutional care).

The **Fiscal Advisory Council** recommends that measures be taken to ensure the **sustained funding** of long-term care and **compliance with the cost-containment path**. **Comparative studies across Austria's provinces** that provide information on **best practices** should be carried out to identify efficiency-enhancing potential. Also, in the medium-term, Austria will need a **public funding model for long-term care** since the costs of long-term care are expected to increase further and family members will

3 Grossmann, B. and P. Schuster (2017). Long-term care in Austria: determinants of public expenditure. Study commissioned by the Austrian Fiscal Advisory Council, Vienna.

no longer be obligated to contribute to the costs.

Risk management should focus on the long term

The strategy of the federal government to incur above all **long-term and fixed interest** debt (taking into account the time structure of repayments) appears to be paying off, given the historically low interest rate level and the current slope of the yield curve, not just for the **federal government but also for all other government authorities**. At the same time it seems useful to make use of negative short- to medium-term interest rates to some extent. Closer **cooperation** on debt management including the related risk management between the federal government, the legal entities of the federal government authorities and the regional authorities is expedient and should be reinforced. The **Fiscal Advisory Council** recommends taking **debt management measures to counteract the risks of rising interest rates** and to address relevant risk scenarios. Care must be taken to keep the investor base broad.