Recommendations by the Fiscal Advisory Council on Austria's Budget Policy and Budget Financing in 2016

Adopted at the Fiscal Advisory Council meeting on November 25, 2015

Economic environment

In its World Economic Outlook of fall 2015, the IMF expects real **global growth** to remain weak at 3.1% in 2015 and to accelerate slightly to 3.6% in 2016. While the growth prospects for the industrialized countries are seen to be improving, a further deterioration is expected for the emerging economies this year, which is down to sluggish growth in oil-exporting countries and China, among other things. The European Commission expects growth in the **euro area** to pick up to 1.6% in 2015 (2014: +0.9%) and accelerate slightly to 1.8% in 2016, with consumer spending being the biggest driver of growth. Export and import growth will be roughly equal, so that the contribution of net exports to growth is expected to be negligible. GDP growth rates are anticipated to be heterogeneous across the euro area: While expected growth rates are clearly above average in Ireland and Spain, they continue to be weak for Italy and Finland over the forecast horizon. In 2015, average real GDP in the euro area is set to reach for the first time the 2007 level again, with ten euro area countries (among them Austria, Germany and Ireland) having a better economic performance than in 2007 and nine countries (e.g. Greece, Italy, Finland and Spain) posting a lower performance. At the same time, the level of investment in 2015 is set to remain below the level of 2007 in most euro area countries, including Austria; only four countries (Germany, Belgium, Malta and Luxembourg) are expected to record higher investment than before the crisis.

Real GDP growth in Austria has been comparatively weak and is expected to come in below 1% for the fourth time in a row in **2015** (+0.7% in 2015 according to the Austrian research institutions WIFO and IHS). Austria's subdued growth in 2015 is attributable to the weak performance of all major demand components. The economic recovery is set to gain strength only in **2016**, with GDP growth anticipated to be around +1.5% (WIFO: +1.4%), mainly on the back of moderate but stable growth in the euro area and the 2015/2016 tax relief on wages and mixed income. In its November 2015 outlook, the European Commission expects real GDP growth to be 0.6% in 2015 and 1.5% in 2016.

The **labor market** dynamics observed since 2011 – employment and unemployment rising at the same time – are set to continue in 2015 and 2016, albeit at a lesser pace than before. While the employment rate is anticipated to grow by 0.8% in 2015 and 0.9% in 2016, the national unemployment rate will increase by 0.8 percentage points and come in at 9.2% in 2015 and 9.7% in 2016 (source: WIFO). This is down to a combination of several factors: First and foremost, labor supply has been rising because of migration and a steady increase in labor participation rates, but it is also the result of restrictions on early retirement.

The **downward risks** to the current economic forecasts are a stronger-than-expected growth slowdown in China as well as a possible drop in sales by Austrian automotive industry suppliers in the wake of the VW emissions scandal. Export-oriented industrial activity has been sending **positive** but weak **signals** since spring 2015, but hardly any positive signals have been recorded for the other sectors. The effects of the refugee crisis on economic growth are difficult to assess at the current juncture; both private and public consumption as well as labor supply might increase more than expected due to the inflow of refugees.

Budget path expected for Austria and EU requirements

According to the **fall forecast of the Fiscal Advisory Council**, Austria will reach the **medium-term budgetary objective (MTO) of a structural budget deficit** of no more than 0.45% of GDP in **2015** (as it did in 2014). The Fiscal Advisory Council's forecast for 2015 – budget deficit (Maastricht definition) of 1.6% of GDP and structural deficit of 0.2% of GDP – is lower than the Austrian finance ministry's deficit estimate of 1.9% of GDP (Maastricht definition) and 0.5% of GDP (structural deficit).

For **2016**, however, the Fiscal Advisory Council anticipates a significant deviation from the **medium-term budgetary objective** according to EU definition: The assessment outlined in its spring forecast – **"significant" deviation** from the structural budget rule in 2016 – still stands after the presentation of the federal government's Draft Budgetary Plan 2016 of October 14, 2015, and in light of the Fiscal Advisory Council's fall forecast. Several factors are seen to weigh on the budget: Austria's weak growth potential, insufficient changes in the revenue and expenditure structure, additional expenditure compared with 2015 for accommodating **refugees and asylum-seekers** (+0.3% of GDP), a net drop in revenues caused by the **2015/2016 tax reform** (+0.3% of GDP) and the expansion of **proactive measures** (universities, broadband infrastructure projects and family support measures: +0.2% of GDP).

According to the fall forecast of the Fiscal Advisory Council, Austria's **debt-to-GDP ratio** is set to increase again in 2015, mainly because of the transfer of liabilities (around EUR 6 billion) to KA Finanz AG, the winddown vehicle for **Kommunalkredit Austria AG**. Thanks to the sale of assets by government winddown companies, government debt is expected to decline by 0.8 percentage points in 2016 (2015: 85.3% of GDP; 2016: 84.5% of GDP). However, it has not been decided yet to which sector the winddown vehicle for Österreichische Volksbanken AG, **Immigon Portfolioabbau AG**, is to be allocated, and this might still impact the 2015 result (Immigon Portfolioabbau AG's total assets as at end-September 2015: EUR 4.8 billion).

Based on current budget developments (excluding the banking package) and the narrowing of the negative output gap (due to lower underutilization), the fall forecast of the Fiscal Advisory Council expects the **structural deficit of the general government** to widen to 1.4% of GDP in 2016 (2015: 0.2% of GDP). **Excluding the additional expenditure for accommodating refugees and asylum-seekers**, Austria's structural deficit would grow to 1.2% of GDP that year. **In both scenarios, Austria will miss** the **medium-term budgetary objective** (–0.45% of GDP) by more than 0.5 percentage points in 2016, which counts as a "**significant**" deviation under EU fiscal rules.

The **European Commission's fall forecast** of November 2015, too, assumes a "significant" rise in Austria's structural budget deficit to 1.0% of GDP in 2016. Excluding the expenditure for refugees and asylum-seekers, which are deemed exceptional, Austria is expected to remain slightly (0.1 percentage point) below the value that would qualify as a significant deviation in 2016 according to the forecast, so that the Commission would **not issue a warning** to Austria from today's point of view.

In contrast, the **federal government's Draft Budgetary Plan (DBP)** of October 2015 essentially assumes that the structural budget deficit will remain unchanged at around 0.5% of GDP. This figure does not include the additional cost of accommodating refugees and asylum-seekers in 2016, which are estimated at EUR 500 million (or 0.14% of GDP) in the DBP.

The **Fiscal Advisory Council's forecasts** are intended as an **early warning mechanism** to help avoid noncompliance with the fiscal rules in Austria. The European Commission will make its assessment of compliance with fiscal rules in 2016 ex post on the basis of its spring 2017 forecast.

In the event of a significant deviation from the fiscal rules, the Council of the European Union issues a recommendation for the necessary adjustment measures within one month and sets a deadline of no more than five months for addressing the deviation (**significant deviation procedure**). Euro area members that fail to comply with the Council recommendations – despite extended deadlines – have to lodge an interest-bearing deposit of 0.2% of GDP.

Recommendations by the Fiscal Advisory Council[1]

Against the backdrop of the current state of public finances and the rules of EU law on budgetary discipline, and in light of the expected economic environment, the **Fiscal Advisory Council** issues the following **recommendations for 2016 and for Austria's medium-term budget path**:

Short- and medium-term budget path and fiscal rules

- The Austrian federal government and the regional and local authorities should continue to **strictly comply with their obligation to observe the EU's fiscal rules** and to **take timely measures to counteract any deviation**, if necessary. In 2015, Austria will probably overachieve its medium-term budgetary objective (MTO of –0.45% of GDP), thus meeting the objective for the second time in a row (2014 and 2015). However, for **2016**, the Fiscal Advisory Council sees the risk of a **significant deviation** from the MTO **according to EU definition**. This deviation must also be expected if the 2016 budget is **adjusted for the costs of accommodating refugees and asylum-seekers**, which qualify as exceptional.

  Austria's **government debt** currently surpasses 85% of GDP. A decline in the debt-to-GDP ratio can be expected for 2016 in light of extremely low interest rate levels and the winding down of nationalized bank assets. Yet, a sustained commitment to fiscal consolidation combined with a positive growth scenario will be needed to reach the maximum public debt level of 60% of GDP.

- The **complexity of national fiscal rules (Austrian Stability Pact 2012)** to be applied from 2017 should be reduced for the **regional and local levels** to the extent possible under EU rules, and the **correction mechanism** which is automatically activated in the event of significant budget deviations should be aligned with current **EU requirements** (European Fiscal Compact, Article 3 para. 1e and 2). To this end, the threshold values that trigger the correction mechanism must be lowered and the time frame for the correction has to be tightened in the Austrian Stability Pact (see "Umsetzung des Korrekturmechanismus zur Einhaltung des mittelfristigen Budgetziels in Österreich" – available in German only; http://www.fiskalrat.at/Publikationen/Sonstige.html).

1 The recommendations were adopted consensually by the 12 voting members of the Council. The fifth recommendation was adopted by majority vote (6 votes in favor, 4 votes against, 2 abstentions).

- The Fiscal Advisory Council's recommendations on the activation, extension or termination of the **correction mechanism** (Article 1 para. 1 no 6d Fiscal Advisory Act 2013) should be strengthened through the introduction of a **"comply or explain" principle** in line with international practice.

Structural reforms, fiscal sharing and fiscal connection

- With regard to **public expenditure**, more budget funds should be **reallocated** to **forward-looking** areas, specifically to **education** and efficient **public investment**, which would help increase the growth-enhancing potential of the public funds spent. The implementation of growth-enhancing budget-neutral measures was also suggested by several high-level experts during a workshop hosted by the Fiscal Advisory Council on "Strategies to foster fiscal discipline and economic growth," as such measures are seen as particularly viable in light of the limited room for fiscal maneuver and low potential growth (see http://www.fiskalrat.at/en/workshops/strategies-to-foster-fiscal-discipline-and-economic-growth.html).

- If **pension** expenditure for 2015 do not increase to the extent anticipated by the **Austrian Committee on Long-Term Pension Sustainability**, this should not be seen as confirmation of the long-term sustainability of the pension system. Expected medium-term pension expenditures are higher than those set out in the legally defined reference scenario but lower than expected earlier. While the measures implemented so far and the continued growth in employment have led to a somewhat slower than expected rise in the federal contribution to pensions, the Committee's long-term projections suggest that additional measures will have to be taken to ensure the adjustment to the reference path in order to safeguard the sustainability of public finances.

- In light of the sharp rise in the number of **asylum-seekers**, the existing legal framework should be evaluated to facilitate the **quick creation of adequate integration and work incentives**. Fast integration into the labor market and the education system is essential to tackling the challenge posed by migration in a successful and sustainable manner, thereby avoiding high follow-up costs for the public sector and society at large.

- The gradual reduction of **nonwage labor costs** agreed upon at the **Austrian labor market summit** of fall 2015 (lowering the contribution under the Insolvency Remuneration Guarantee Act by 0.1 percentage point from 2016 and cutting the contribution to the Family Burden Equalization Fund by a total of 0.6 percentage points from 2017/2018) should be implemented in a way that does not compromise the **consolidation path**. Reducing the tax burden on labor is a sensible step toward strengthening labor demand in light of high labor supply (due to immigration and higher participation rates).

- In the course of negotiating the new fiscal sharing arrangements for 2017, a **fiscal sharing system** should be launched that is as simple as possible and **task-oriented**, provides a higher level of **direct responsibility** for the responsible authorities and allows the **disentangling of joint tasks** at all levels. To this end, **as-is and to-be analyses** should be conducted in advance of the negotiations for **tasks undertaken jointly by different levels of government** (e.g. education, subsidies, local transport, health care, care etc.), and **study results should be used** to discuss existing structures, objectives and financial flows. In the Fiscal Advisory Council's view, the principles of **fiscal equivalence** (i.e. beneficiaries and payers coincide) and **fiscal**

connection (i.e. the responsibilities for tasks, expenditures and revenues are combined) should have a high priority in the redesign of the fiscal architecture. In addition to these criteria of efficiency, the (fiscal) capacity of federal, regional and local authorities should be taken into consideration, and an equalization of resources should be provided for structurally weak regions. **Package deals** that cover large areas of reform might help achieve viable **compromises** by balancing divergent interests.

Transparency and budget rules

- The new fiscal arrangement should provide for **transparent and comprehensive** information on the **financial flows** between the contracting partners.

- Stakeholders should make full use of the **period before the 2015 Budgeting and Accounts Regulation (VRV) becomes effective for regional and local authorities** (in 2019 and 2020, respectively) to ensure uniform and workable implementation of the new system **in a shorter period of time** than granted under the law.

  The **Fiscal Advisory Council welcomes the adoption of the new VRV** with its integrated financial, economic outturn and capital accounts, as the regulation provides a common framework for the structure and presentation of budgets and accounts by regional and local authorities as well as a basis for more transparency.

  In a first step, efforts should be undertaken to initiate the harmonization of **accounting practices** so as to improve fiscal governance in Austria and create comparable databases. In addition**, standardized training programs** should be provided in the preparatory phase. A **binding** and regularly updated **electronic accounting guide for regional and local authorities** would also help harmonize accounting practices.

- An **amendment to the financial constitution** should be considered to create a binding legal basis for coherent **medium-term fiscal planning** for all subsectors, which is required under Article 13 of Directive 2011/85/EU, and to **strengthen impact orientation** in budget planning. The administrative work involved in the application of such instruments should be in proportion to the benefits, though. Experience has shown that impact orientation at the federal level tends to lead to disproportionate administrative burdens.

- The **foundations for high-quality and comprehensive databases** should be laid for the purpose of **establishing budgetary outcomes under the 2012 Austrian Stability Pact**. The statistical information under ESA 2010 on government revenues and expenditures from the individual provinces (regional and local breakdown) has not been established to date, but this information is a prerequisite for monitoring compliance with fiscal rules at the subsectoral level as set out in the Austrian Stability Pact.

- The Fiscal Advisory Council should be given the **same right to information** in its fields of activity as **Austrian members of parliament** (national council, the lower chamber of parliament). At present, mandatory reports delivered by the executive branch to the legislative branch (national council, provincial parliaments) are generally classified secret (e.g. **reports submitted under the Federal Budget Act 2013**), which complicates the continuous evaluation of the fiscal stance in Austria. The **Fiscal Advisory Council's statutory right to information** should be extended or reinterpreted to include information submitted by the ministries to the Parliamentary Budget or Financial Committee.