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# Stimulating Effects of Tax Cuts Dampened by Counter-Financing Measures

## Economic Outlook for 2015 and 2016

### Stimulating Effects of Tax Cuts Dampened by Counter-Financing Measures. Economic Outlook for 2015 and 2016

At a projected rate of 0.5 percent for 2015, GDP growth in Austria remains subdued for the fourth consecutive year. With intra-EU trade picking up in 2016, domestic growth should accelerate to 1.3 percent. Exports will also be sustained by the significant depreciation of the euro. The tax reform 2015-16 will give support to private demand, while restraining public consumption. The moderate pace of growth over the projection period will not bring the rise in unemployment to a halt.

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GDP growth for Austria is projected at 0.5 percent for 2015 and 1.3 percent for 2016, unchanged from the forecast of last March. Sluggish activity is thus extending into its fourth year, to be followed by a gradual recovery in 2016 that is nevertheless unlikely to improve the situation on the labour market, as the unemployment rate (on national definition) will climb to 9.6 percent. The slight acceleration of growth in 2016 is largely owed to a brightening external environment. While the tax cuts will strengthen private domestic demand, the positive stimulus will be dampened by the restraining effects of the counter-financing measures on public consumption, such that the overall growth effects of the tax reform will be negligible until 2016<sup>1</sup>.

Both international and domestic factors are responsible for the continued cyclical sluggishness in 2015. Private household incomes are eroded by a comparatively high rate of inflation, notably for housing rents, a high tax burden by international standards and a critical labour market situation. Although the tax burden will be alleviated by the tax reform in 2016, the stimulating effects will be offset on the one hand by the counter-financing measures. On the other hand, over half of the implicit net income gains will not add to final demand in the short term but rather boost private savings, since the major beneficiaries are middle- and high-income earners with a

<sup>1</sup> In the medium run (until 2019) the impact of the tax reform on GDP is projected at +¼ percent (Baumgartner, J., Kaniowski, S., "Steuerreform 2015/16 – Gesamtwirtschaftliche Wirkungen bis 2019", WIFO-Monatsberichte, 2015, 88(5), pp.399-416, <http://monatsberichte.wifo.ac.at/58171>), in the long term at up to +0.4 percent (Streicher, G., "Schätzung der Auswirkungen der Steuerreform 2015/16 auf die Wertschöpfung mit dem Modell FIDELIO", WIFO-Monatsberichte, 2015, 88(5), pp.417-424, <http://monatsberichte.wifo.ac.at/58172>).

below-average propensity to consume. Further effects of the tax reform and higher residential investment (beyond the projects planned by the Federal Real Estate Agency BIG and already included in the WIFO Economic Outlook of last March) will only materialise as from 2017. The recovery in 2016 therefore hinges primarily upon a pick-up in foreign demand and the associated stimulus to domestic investment. Notably a rebound of industrial production in Europe would be crucial for Austrian exporters heavily specialising in investment goods. Manufacturing output in Germany, Austria's number-one foreign market, is still flat, and lacklustre German imports have so far delayed a recovery in trading partner countries. Yet, the marked decline in the euro exchange rate should benefit industrial production. Also, strengthening private consumption in several EU countries will spill over to domestic investment and give impetus to intra-European trade and thus to Austrian exports.

Should industrial production in Germany and Austria not take off as assumed in the present forecast, a cyclical recovery in 2016 would be doubtful. An earlier and stronger revival may set in should the tax cuts turn out to be counter-financed to a lesser extent than anticipated. In that case, however, the general government deficit would edge up rather than abate from 2.1 percent to 1.9 percent of GDP, as outlined in the present projection.

Table 1: Main results

		2011	2012	2013	2014	2015	2016
		Percentage changes from previous year					
GDP							
Volume		+ 3.1	+ 0.9	+ 0.2	+ 0.3	+ 0.5	+ 1.3
Value		+ 4.9	+ 2.8	+ 1.7	+ 2.0	+ 1.9	+ 2.9
Manufacturing <sup>1</sup> , volume		+ 9.0	+ 1.1	+ 0.6	+ 0.1	± 0.0	+ 2.5
Wholesale and retail trade, volume		+ 3.6	- 0.1	- 1.6	- 0.7	+ 0.7	+ 1.7
Private consumption expenditure, volume		+ 0.7	+ 0.6	- 0.1	+ 0.2	+ 0.4	+ 1.3
Gross fixed investment, volume		+ 6.8	+ 0.5	- 1.5	+ 0.4	+ 0.5	+ 1.5
Machinery and equipment <sup>2</sup>		+ 9.8	- 0.6	- 1.5	+ 1.7	+ 0.5	+ 2.5
Construction		+ 2.6	+ 1.2	- 2.2	+ 0.1	+ 0.5	+ 1.0
Other investment <sup>3</sup>		+ 12.9	+ 0.5	+ 0.3	- 0.9	+ 0.5	+ 1.2
Exports of goods <sup>4</sup>							
Volume		+ 7.1	+ 0.6	+ 2.8	+ 2.1	+ 3.0	+ 4.0
Value		+ 11.3	+ 1.5	+ 1.8	+ 1.7	+ 2.2	+ 4.7
Imports of goods <sup>4</sup>							
Volume		+ 8.3	- 0.9	+ 0.2	+ 0.9	+ 2.5	+ 3.5
Value		+ 15.3	+ 0.7	- 1.0	- 0.8	+ 1.0	+ 4.5
Current balance	billion €	+ 5.06	+ 4.73	+ 3.06	+ 2.56	+ 3.14	+ 3.16
As a percentage of GDP		+ 1.6	+ 1.5	+ 0.9	+ 0.8	+ 0.9	+ 0.9
Long-term interest rate <sup>5</sup>	percent	3.3	2.4	2.0	1.5	0.5	0.5
Consumer prices		+ 3.3	+ 2.4	+ 2.0	+ 1.7	+ 1.2	+ 1.7
Unemployment rate							
Eurostat definition <sup>6</sup>	percent	4.6	4.9	5.4	5.6	5.7	5.8
National definition <sup>7</sup>	percent	6.7	7.0	7.6	8.4	9.3	9.6
Persons in active dependent employment <sup>8</sup>		+ 1.9	+ 1.4	+ 0.6	+ 0.7	+ 0.6	+ 0.7
General government financial balance according to Maastricht definition							
As a percentage of GDP		- 2.6	- 2.2	- 1.3	- 2.4	- 2.1	- 1.9

Source: WIFO, 2015 and 2016: forecast. – <sup>1</sup> Value added, including mining and quarrying. – <sup>2</sup> Including weapon systems. – <sup>3</sup> Intellectual property products and cultivated biological resources. – <sup>4</sup> According to Statistics Austria. – <sup>5</sup> 10-year central government bonds (benchmark). – <sup>6</sup> According to Eurostat Labour Force Survey. – <sup>7</sup> According to Public Employment Service Austria, as a percentage of total labour force excluding self employed. – <sup>8</sup> Excluding parental leave, military service.

## 1. World trade momentum, oil prices and growth of emerging markets all weaker than expected

Against the assumption underlying the WIFO forecast of March 2015, the momentum of world trade slowed in the first three months of the year. The exchange of goods, having expanded by 3.7 percent each in the third and fourth quarter 2014, gained only 2.4 percent in the first quarter 2015, although falling oil prices made industrial countries' imports of intermediate goods cheaper and the repeated devaluation of the yen in the second half of 2014 stimulated Japanese exports. However, global trade growth was dampened early this year by slackening imports of Asian emerging markets. The unexpectedly sharp cyclical downturn in the region may also have added to the slump in prices of oil and other raw materials. The combination of supply-side (the maintenance of oil output levels by OPEC) and demand-side factors (disappointing cyclical developments in major oil-importing countries) accelerated the oil price decline towards the end of 2014. The latter should thus be seen not only as a welcome supply shock, but also as a result of unexpected cyclical sluggishness that probably diminishes its ex-ante positive effect on business activity.

These latest events suggest the following revisions to the short-term outlook: at a projected rate of 3.4 percent, world trade in 2015 will expand less than so far assumed; the Chinese economy is expected to grow by only 6.5 percent; and the benchmark price of oil (Brent) will not exceed \$ 70 per barrel during the forecast period. Supply conditions on oil markets have changed over the last years: shale oil producers in the USA may meanwhile have taken over from OPEC members the role of swing producers, in that they raise supply in order to prevent further hikes once oil prices rise above \$ 70 per barrel. The Persian Gulf States as the most influential group within the OPEC cartel, who themselves have triggered price shocks as swing producers in the past, will not reduce output levels in order to maintain their market share.

*Adverse developments in the emerging markets weigh on world trade growth and on demand for investment goods.*

Table 2: World economy

	2011	2012	2013	2014	2015	2016
	Percentage changes from previous year					
<i>Real GDP</i>						
World	+ 4.2	+ 3.4	+ 3.4	+ 3.4	+ 3.1	+ 3.4
USA	+ 1.6	+ 2.3	+ 2.2	+ 2.4	+ 2.4	+ 2.4
Japan	- 0.5	+ 1.7	+ 1.6	- 0.1	+ 1.2	+ 1.4
EU 28	+ 1.7	- 0.5	± 0.0	+ 1.3	+ 1.7	+ 1.8
Euro area 19	+ 1.6	- 0.8	- 0.4	+ 0.9	+ 1.3	+ 1.5
Germany	+ 3.6	+ 0.4	+ 0.1	+ 1.6	+ 1.4	+ 1.7
CEEC 5 <sup>1</sup>	+ 3.3	+ 0.5	+ 1.0	+ 3.0	+ 2.9	+ 3.1
China	+ 9.3	+ 7.8	+ 7.8	+ 7.4	+ 6.5	+ 6.5
World trade, volume	+ 6.0	+ 2.1	+ 2.7	+ 3.3	+ 3.4	+ 4.2
Market growth <sup>2</sup>	+ 7.4	+ 0.8	+ 1.9	+ 3.3	+ 3.0	+ 4.0
<i>Primary commodity prices<sup>3</sup></i>						
HWI index, total	+ 28.6	- 2.8	- 1.9	- 7.0	- 28	+ 4
Excluding energy	+ 19.2	- 14.4	- 6.1	- 6.2	- 24	- 8
<i>Crude oil prices</i>						
Brent, \$ per barrel	111.3	111.6	108.7	99.0	65	70
<i>Exchange rate</i>						
\$ per euro	1.392	1.286	1.328	1.329	1.10	1.10

Source: WIFO. 2015 and 2016: forecast. – <sup>1</sup> Czech Republic, Hungary, Poland, Slovakia, Slovenia. – <sup>2</sup> Real import growth of goods of trading partners weighted by Austrian export shares. – <sup>3</sup> Dollar.

The significant appreciation of the dollar should not be seen as independent of the oil price decline. Since crude oil is traded in dollar world-wide and financial market hedging plays an important role, both prices often move in opposite direction. Without the simultaneous effective revaluation of the dollar, both vis-à-vis the yen and the euro, an oil price fall of the extent observed would probably not have occurred. Extrapolating a low oil price, as underlying the present forecast, therefore goes hand in hand with assuming continued strength of the dollar and weakness of the euro.

*Low oil prices are accompanied by a stronger dollar.*

Unlike the impact of yen-devaluation in Japan, the weaker euro is not boosting euro area exports for the time being. The reason is probably that the euro, as different from the yen, has seen an appreciation since 2012 that has only been offset when the exchange rate abated to \$ 1.2 per € at the end of 2014. Any stimulating impact on activity may thus be expected only as from the second half of 2015. The Austrian economy stands to benefit not only via direct trade with third countries, but also via the boost to industrial output in European trading partner countries triggered by the weaker euro.

## 1.2 No acceleration of US growth

Real GDP in the USA edged down by 0.2 percent from the previous period in the first quarter 2015. The setback was due not only to slower export growth as a result of the marked effective appreciation of the dollar, but also to slackening domestic demand. Even if, apart from cyclical factors, one-off effects like severe winter conditions were responsible for the decline that may be made up for in subsequent months, an acceleration of growth from 2014 appears unlikely. The strength of the dollar and a tightening of monetary policy, as announced by the Fed for the remainder of the year, will exert a restraining impact on activity. Wage growth, on the other hand, is set to pick up given the improvement on the labour market, sustaining private incomes and consumption. Real GDP growth is therefore expected to remain at a steady annual rate of 2.4 percent over the forecast period.

## 2. Cyclical recovery spreading across the EU

After Germany, the UK and Spain, the cyclical recovery in Europe extended to Italy and France in early 2015. In the latter two economies, benign one-off factors due to the oil price slump and cheaper intermediate goods and energy-intensive consumer goods have probably played an important role. In Germany, the satisfactory labour market situation bodes well for continued solid growth of wages and private consumption; indeed, the long-lasting wage restraint has for the last two years given way to wage increases in line with productivity growth. The decline in unemployment has also strengthened the bargaining power of labour in wage negotiations. Apart from stronger wage dynamics, special factors like the introduction of new retirement benefits and of a statutory minimum wage will add to private purchasing power. In this respect, growth conditions since mid-2013 markedly differ from earlier periods of expansion (like in 2004, mid-2005 to mid-2008 or 2010-11) when the contributions of net exports and investment to GDP growth regularly exceeded that of private consumption. GDP growth in Germany is projected at 1.4 percent for 2015 and 1.7 percent for 2016.

In Ireland and Portugal, which had both been hit by a balance-of-payments crisis in 2011 and 2012, the recovery is progressing, whereas the situation in Greece remains uncertain. The cyclical outlook for the countries of East-Central Europe is altogether positive, as flexible exchange rates enable them to better adjust to changing external conditions.

### 2.1 Government bond purchases by the ECB forcing down the exchange rate

Since at the present juncture it could not attain its goal of price stability by conventional instruments, the ECB in March 2015 launched a comprehensive programme of purchasing euro area government bonds. This measure has different effects:

- It provides relief for the financial sector. The demand by the ECB raises the price of government bonds and thereby improves the asset position of banks and insurance companies who hold these bonds or sell them to the ECB.
- The external value of the euro declines in anticipation of the rising price and hence the lower yield on euro-denominated fixed-interest securities. Exporting companies will benefit to the extent that higher demand for their products outweighs the price increase for inputs paid in foreign currency.

*In early 2015, economic growth returned to France and Italy.*

*In the absence of accompanying fiscal stimulus, the expansionary monetary policy by the ECB only comes across via the depreciation of the euro.*

- Refinancing conditions of companies will improve. The ECB measure raises prices not only for government bonds, but via portfolio effects also for other financial assets like corporate bonds and shares. Companies will thus benefit both via external and internal financing channels.
- Incurring new debt is being facilitated. With obligations being at fixed interest, it would be meaningful to take on new debt. However, many companies hesitate to step up investment, given poor sales prospects. Governments, for their part, being bound by fiscal rules, are reluctant to increase their budget deficits.

Hence, without an accompanying relaxation of the fiscal stance or incentives for structural reform, the potential cyclical stimulus from the expansionary monetary measures will largely be confined to the depreciation of the euro. Via this effect and the implicit rise in import prices, the desired pick-up in domestic inflation will be achieved.

### 3. Sluggish business activity in Austria

Having stagnated during the second half of 2014, demand and output in Austria edged up by 0.1 percent in the first quarter 2015 from the previous period. Private consumption had bottomed out in the first six months of 2014 and has been tentatively heading up since, whereas in the second half of the year activity mainly suffered from the decline in gross fixed capital formation. The retrenchment of construction investment lost momentum in early 2015. Exports recovered somewhat, while remaining at a moderate pace. It is only in a couple of months that the marked depreciation of the euro will exert its full impact, suggesting more buoyant export growth as from the second half of 2015.

#### 3.1 Exports to benefit from euro weakness

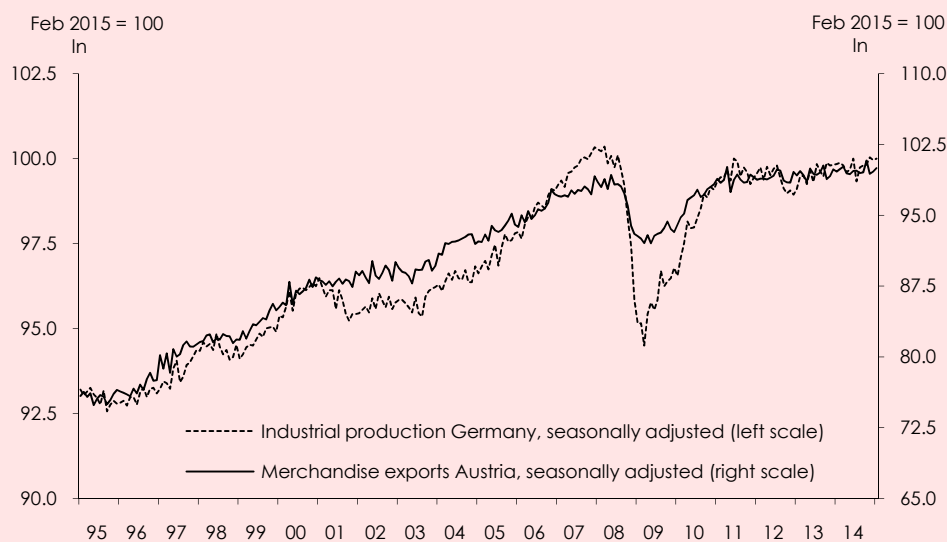
More than half of Austrian exports go to other euro area countries. The exchange rate effect is nevertheless of relevance also for intra-euro-area-trade, since an increase in demand from third countries for exports of a euro area country spurs investment in that country and hence supplies from Austria that are necessary for such investment. A crucial destination country is Germany which takes up 30 percent of Austrian exports. The major part of Austria's exports are investment goods, mainly for the machine tools and the motor car industry; Austrian exporters therefore do not directly benefit from the current consumption strength in Germany. Austria's merchandise exports and German industrial production have over large periods exhibited a synchronised pattern during the last 20 years and have both stagnated since 2011 (Figure 1). Yet, at the beginning of the 2000s, Austrian exports kept rising solidly despite sluggish industrial production in Germany, since they were supported by booming activity in other euro area countries and in East-Central Europe. An increase in German industrial output is typically associated with a growth rate 3½ times as high as that of Austrian merchandise exports. Such high export elasticity benefits business activity in Austria in periods of cyclical expansion. Conversely, stagnation of output in Germany adversely affects Austria to considerable extent, particularly since at present, unlike in the early 2000s, compensating stimulus from other countries is lacking or feeble.

Thanks to specialisation and focussing on market niches, Austrian exporters benefit from the capital-intensive catching-up process in emerging markets mainly via the supply of components to other industrialised countries like Germany. This catching-up process has recently faltered for different reasons and is unlikely to return to earlier strength over the forecast horizon. Also the transition to domestic production of machinery and motor cars in the emerging markets, notably in China, poses new challenges for German manufacturers and their suppliers. While Austrian companies, on account of the quality of their products, are still highly competitive on world markets, their specialisation is now acting as a constraint, given the changes in the external environment like the slowdown of investment in third countries or the shift of aggregate demand towards private consumption in Germany. A further dampening factor are the adverse trade effects of the economic sanctions against Russia.

*Stronger industrial output growth in Germany is a pre-condition for Austrian exports to pick up.*

However, in the further course of the year, the revival of consumption in the euro area will lead to higher investment. Industrial activity in the EU at large and in Austria will receive stronger incentives from the depreciation of the euro, such that growth of goods exports should edge up from 3 percent in 2015 to 4 percent in 2016.

Figure 1: Austrian merchandise exports and German industrial production



Source: Statistics Austria, Eurostat, WIFO calculations. Merchandise exports according to foreign trade statistics. Production in industry NACE 2008, sections B to D. The different scaling reveals that for a given increase in Germany's industrial production Austria's merchandise exports rise disproportionately, by a factor around 3½.

### 3.2 Investment recovering only slowly

The slight revival of industrial production since December 2014 continued into early 2015, without gathering momentum. According to the regular WIFO Business Cycle Survey of last May, firms are on the whole sceptical with regard to the current business trend and the short-term outlook. Firms' expectations remained on balance negative (index for the overall economy -1.3 points, for manufacturing -3.7 points). Companies' expectations in the service sector improved somewhat, the index value of 1.8 being in positive territory, but still being below the average of the last few years. The WIFO Leading Indicator for May was unchanged from the previous month, bringing the upward trend of the last few months to a halt. The different components of the indicator show no clear trend, but the overall stagnation is reflected by both domestic and external components.

Latest results of the Economic Barometer ("Wirtschaftsbarometer") released by the Austrian Federal Economic Chamber confirm the stagnation of activity. All forward-looking indicators are on balance negative, except for export earnings. Firms particularly remain cautious with regard to investment, with replacement of obsolete business equipment dominating the enlargement of productive capacity. Results differ with regard to firm size: large companies express greater optimism for the next twelve months than small and medium-sized firms.

Since investment typically reacts with a lag to a pick-up in exports as assumed in the present forecast, purchases of machinery and equipment will remain muted in 2015 (+0.5 percent), before gradually rebounding in 2016 (+2.5 percent).

The projection for construction investment includes as from 2016 the housing programme of the Federal Real Estate Agency ("Bundesimmobiliengesellschaft") which provides for the construction of 10,000 dwellings over the next six years, at a total cost of € 2 billion. Since the WIFO forecast of last March, a further comprehensive housing programme to the amount of € 5.75 billion has been adopted, whereby 30,000 dwellings are to be created over a period between five and seven years. Since, however, its implementation is being delayed, early effects on investment in

Leading indicators compiled by WIFO and the Austrian Federal Economic Chamber do not signal an early pick-up from sluggish production and investment.

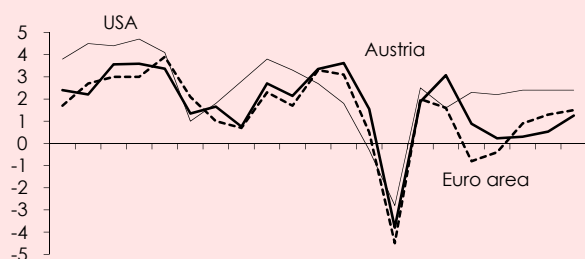
The currently planned residential building projects have a long lead time until implementation, such that the stimulating effect on construction activity will materialise only as from 2016-17.

construction should not be expected before 2017; an adjustment of the projection for investment in construction until 2016 has not been deemed necessary.

Figure 2: Indicators of economic performance

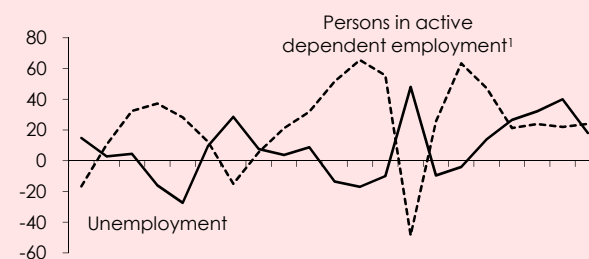
#### Growth of real GDP

Percent



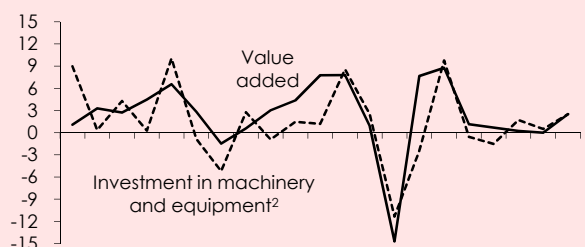
#### Employment and unemployment

1,000 from previous year



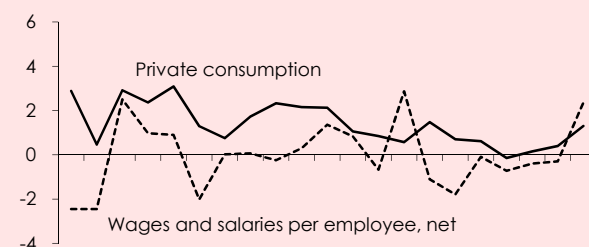
#### Manufacturing and investment

Percentage changes from previous year, volume



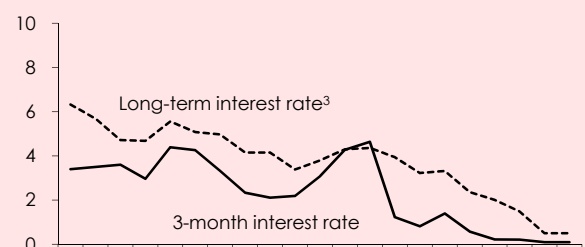
#### Consumption and income

Percentage changes from previous year, volume



#### Short-term and long-term interest rates

Percent



#### Inflation and unit labour costs

Percentage changes from previous year



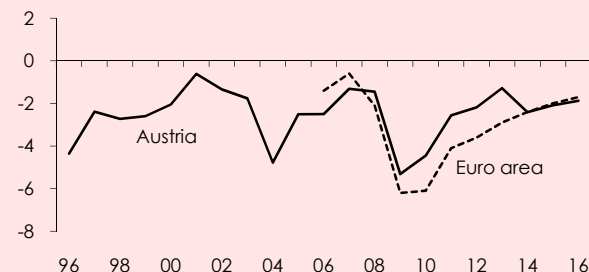
#### Trade

Percentage changes from previous year, volume



#### General government financial balance

As a percentage of GDP



Source: WIFO, 2015 and 2016: forecast. – <sup>1</sup> Excluding parental leave, military service, and unemployed persons in training. – <sup>2</sup> 10-year central government bonds (benchmark).

### 3.3 Tax reform raises saving and consumption by private households

The present projection is the first one to incorporate the impact of the tax reform that takes effect in 2016 (see also further below). It rests on the assumption that the measures adopted (Ministerial Council Draft of 17 March 2015, drafts circulated for

consultation) will be implemented in full and without delay. The forecast for real GDP remains unchanged as in the short run the positive and the negative effects on aggregate demand will cancel out. Yet, the composition of final demand will shift markedly from public towards private consumption.

*In the short run, the tax reform 2015-16 squeezes public consumption to the same extent as it boosts private demand, leaving for 2016 a neutral effect on GDP.*

Table 3: Private consumption, income and prices

	2011	2012	2013	2014	2015	2016
	Percentage changes from previous year, volume					
Private consumption expenditure	+ 0.7	+ 0.6	- 0.1	+ 0.2	+ 0.4	+ 1.3
Durables	+ 4.6	- 0.1	- 3.2	+ 0.1	+ 0.5	+ 3.8
Non-durables and services	+ 0.3	+ 0.7	+ 0.2	+ 0.2	+ 0.4	+ 1.0
Household disposable income	- 1.1	+ 1.9	- 2.1	+ 0.4	+ 0.4	+ 2.0
	As a percentage of disposable income					
Household saving ratio						
Including adjustment for the change in net equity of households in pension fund reserves	7.8	9.0	7.3	7.5	7.5	8.1
Excluding adjustment for the change in net equity of households in pension fund reserves	7.1	8.3	6.5	6.7	6.7	7.3
	Percentage changes from previous year					
Direct lending to domestic non-banks <sup>1</sup>	+ 2.7	+ 0.0	- 1.2	+ 0.3	+ 1.0	+ 1.2
	Percentage changes from previous year					
Inflation rate						
National	3.3	2.4	2.0	1.7	1.2	1.7
Harmonised	3.6	2.6	2.1	1.5	1.1	1.7
Core inflation <sup>2</sup>	2.8	2.3	2.3	1.9	1.8	1.7

Source: WIFO. 2015 and 2016: forecast. – <sup>1</sup> End of period. – <sup>2</sup> Excluding unprocessed food (meat, fish, fruits, vegetables) and energy items.

Table 4: Earnings and international competitiveness

	2011	2012	2013	2014	2015	2016
	Percentage changes from previous year					
Gross earnings per employee <sup>1</sup>	+ 1.8	+ 2.7	+ 1.7	+ 1.8	+ 1.5	+ 1.7
Gross real earnings per employee <sup>2</sup>	- 1.4	+ 0.3	- 0.3	+ 0.1	+ 0.3	+ 0.0
Net real earnings per employee <sup>2</sup>	- 1.8	- 0.1	- 0.7	- 0.4	- 0.3	+ 2.4
Unit labour costs						
Total economy	+ 0.5	+ 2.9	+ 2.4	+ 2.4	+ 1.9	+ 1.4
Manufacturing	- 3.2	+ 3.7	+ 1.8	+ 1.9	+ 1.5	- 0.4
Effective exchange rate, manufactures						
Nominal	+ 0.1	- 1.7	+ 1.8	+ 1.2	- 3.3	- 0.1
Real	+ 0.5	- 1.7	+ 2.1	+ 1.5	- 3.1	- 0.3

Source: WIFO. 2015 and 2016: forecast. – <sup>1</sup> Employees according to National Accounts definition. – <sup>2</sup> Deflated by CPI.

The tax reform will raise real disposable income of private households by 0.9 percent in 2016. Since the emphasis of the tax relief is on middle and higher incomes, about half of the net income gain will in the first instance go to the saving accounts and not translate into higher final demand; hence, the private saving ratio will go up by ½ percentage point. Private consumption will increase by 0.4 percent – demand for durable consumer goods by an above-average rate – and the implicit improvement in sales prospects should encourage firms to higher investment. However, the counter-financing measures will restrain public consumption by 1.1 percent (smaller increase for intermediate goods and administrative expenditure). In addition, the demand impact of the tax relief will be diminished by the compulsory introduction of cash registers for many service providers which will lead to taxation of incomes previously earned in the "grey economy". Without the counter-financing measures, the tax relief would boost private disposable income by around 2 percent in 2016, pri-



vate consumption by 0.9 percent and real GDP by an estimated 0.4 percent. The general government deficit would in that case widen to 2.8 percent of GDP.

Due to revised assumptions for oil prices and the euro/dollar exchange rate, the forecast for the rate of inflation is taken down by 0.1 percentage point each for 2015 and 2016 from the projection of last March. The tax reform, and in particular the counter-financing measures (increase in the reduced VAT rate, cut in subsidies and the partial pass-through of the tax burden for hitherto undeclared transactions) will push up the inflation rate by 0.3 percentage points. In all, headline inflation is expected at an annual 1.2 percent for 2015 and 1.7 percent for 2016.

Headline inflation dampened by low oil prices, but slightly raised by the tax reform.

### 3.4 Services branches sustaining employment growth

Total hours worked in the manufacturing sector is receding in 2015 on account of personnel reductions as well as lower hours worked per capita. The increase in employment in the economy as a whole (2015 +0.6 percent, 2016 +0.7 percent) is largely driven by job creation in the service sector, to a large extent concerning part-time jobs. The total number of persons employed (National Accounts definition, dependent employees and self-employed) is expected to rise by 0.9 percent in 2015 and by 0.8 percent in 2016. The increase goes hand in hand with a cut in hours worked per capita, implying virtual stagnation of total total hours worked in the economy over the forecast period.

Table 5: Labour market

	2011	2012	2013	2014	2015	2016	
	Changes from previous year, in 1,000						
<i>Demand for labour</i>							
Persons in active employment <sup>1</sup>	+ 69.9	+ 50.1	+ 29.3	+ 30.2	+ 27.0	+ 29.0	
Employees <sup>2</sup>	+ 63.3	+ 47.2	+ 21.2	+ 23.8	+ 22.0	+ 24.0	
Percentage changes from previous year	+ 1.9	+ 1.4	+ 0.6	+ 0.7	+ 0.6	+ 0.7	
Nationals	+ 25.7	+ 9.0	- 8.5	- 8.1	- 1.0	- 1.0	
Foreign workers	+ 37.7	+ 38.1	+ 29.7	+ 32.0	+ 23.0	+ 25.0	
Self-employed <sup>3</sup>	+ 6.6	+ 2.9	+ 8.1	+ 6.4	+ 5.0	+ 5.0	
<i>Labour supply</i>							
Population of working age							
15 to 64 years	+ 31.3	+ 18.0	+ 23.5	+ 33.1	+ 25.5	+ 23.3	
15 to 59 years	+ 11.7	+ 22.3	+ 27.2	+ 33.7	+ 18.7	+ 8.5	
Labour force <sup>4</sup>	+ 65.8	+ 64.0	+ 55.9	+ 62.4	+ 67.0	+ 47.0	
<i>Surplus of labour</i>							
Registered unemployed <sup>5</sup>	- 4.1	+ 13.9	+ 26.6	+ 32.2	+ 40.0	+ 18.0	
In 1,000	246.7	260.6	287.2	319.4	359.4	377.4	
Unemployed persons in training <sup>5</sup>	in 1,000	63.2	66.6	73.5	75.3	61.3	58.3
In percent							
Unemployment rate							
Eurostat definition <sup>6</sup>	4.6	4.9	5.4	5.6	5.7	5.8	
As a percentage of total labour force <sup>5</sup>	6.0	6.2	6.8	7.4	8.2	8.6	
National definition <sup>5,7</sup>	6.7	7.0	7.6	8.4	9.3	9.6	
Employment rate							
Persons in active employment <sup>1,8</sup>	66.6	67.2	67.5	67.6	67.8	68.0	
Total employment <sup>6,8</sup>	71.1	71.4	71.4	71.1	71.2	71.3	

Source: WIFO. 2015 and 2016: forecast. – <sup>1</sup> Excluding parental leave, military service. – <sup>2</sup> According to Federation of Austrian Social Security Institutions. – <sup>3</sup> According to WIFO. – <sup>4</sup> Persons in active employment plus unemployment. – <sup>5</sup> According to Public Employment Service Austria. – <sup>6</sup> According to Eurostat Labour Force Survey. – <sup>7</sup> As a percentage of total labour force, excluding self-employed. – <sup>8</sup> As a percentage of population of working age (15 to 64 years).

The shrinking of domestic labour supply will be more than offset by the inflow of labour from abroad. With labour supply outpacing demand, the unemployment rate keeps rising to 9.3 percent in 2015 and 9.6 percent in 2016. Since the domestic population of working age is shrinking, the increase in labour supply and employment is driven by inflow of foreign workers, including cross-border commuters. In addition, labour supply of 50-year-olds and above is growing, due to strong age cohorts in this bracket and to restrictions imposed on early retirement.

Table 6: Productivity

	2011	2012	2013	2014	2015	2016
	Percentage changes from previous year					
<i>Total economy</i>						
Real GDP	+ 3.1	+ 0.9	+ 0.2	+ 0.3	+ 0.5	+ 1.3
Hours worked <sup>1</sup>	+ 2.0	- 0.1	- 0.5	+ 0.8	± 0.0	+ 0.1
Productivity per hour	+ 1.1	+ 1.0	+ 0.7	- 0.5	+ 0.5	+ 1.2
Employment <sup>2</sup>	+ 1.7	+ 1.1	+ 0.7	+ 0.9	+ 0.9	+ 0.8
<i>Manufacturing</i>						
Production <sup>3</sup>	+ 8.8	+ 1.2	+ 0.7	+ 0.2	± 0.0	+ 2.5
Hours worked <sup>1</sup>	+ 1.6	+ 1.2	- 0.4	- 0.6	- 0.6	+ 0.2
Productivity per hour	+ 7.0	- 0.1	+ 1.1	+ 0.9	+ 0.6	+ 2.3
Employees <sup>1</sup>	+ 1.9	+ 1.6	- 0.1	+ 0.1	- 0.3	+ 0.1

Source: WIFO. 2015 and 2016: forecast. – <sup>1</sup> According to National Accounts definition. – <sup>2</sup> Dependent and self-employed according to National Accounts definition. – <sup>3</sup> Value added, volume.

### 3.5 Tax reform 2015-16 may be implemented in a deficit-neutral way

In March 2015, the federal government agreed on a tax reform the main parts of which shall enter into force on 1 January 2016. The reform will lower the revenues from wage and income tax by € 4 billion, about 1.1 percent of projected GDP), mainly via an adjustment of the income tax schedule (€ 3.7 billion). In order to counter-finance the revenue losses, the federal government envisages a series of measures concerning mainly the fight against tax fraud and the evasion of public charges, but also various tax hikes (totalling € 2.5 billion in 2016, of which € 1.9 billion anti-tax-fraud measures). Net of these revenue-raising measures, the reform will ease the tax burden by € 1.5 billion in 2016. In addition, the central and the state governments shall reduce spending on administration and subsidies by an overall € 1.1 billion. If all counter-financing measures are implemented timely and in full, the introduction of the tax reform 2015-16 may be neutral to the budget balance. Under these preconditions, the general government deficit for 2015 is expected at 2.1 percent of GDP, narrowing to 1.9 percent of GDP in 2016.

The persistent low interest rates on public debt exonerate government budgets in refinancing existing and incurring new debt. On the other hand, the unfavourable labour market situation requires additional counter-cyclical expenditure that will help stabilise private consumption. Further financial support for banks in distress is assumed at € 1.7 billion for 2015 and € 0.6 billion for 2016. Should the tax-increasing and expenditure-reducing measures to counter-finance the income tax cut be implemented only partially or with delay, the general government deficit for 2016 will widen accordingly, while providing a stronger incentive for business activity. A further budgetary risk relates to support for ailing banks that may exceed the amount assumed in the present context.

Table 7: Key policy indicators

	2011	2012	2013	2014	2015	2016
	As a percentage of GDP					
<i>Fiscal policy</i>						
General government financial balance						
According to Maastricht definition	- 2.6	- 2.2	- 1.3	- 2.4	- 2.1	- 1.9
General government primary balance	0.2	0.5	1.2	- 0.0	0.2	0.4
	In percent					
<i>Monetary policy</i>						
3-month interest rate	1.4	0.6	0.2	0.2	0.1	0.1
Long-term interest rate <sup>2</sup>	3.3	2.4	2.0	1.5	0.5	0.5
	Percentage changes from previous year					
<i>Effective exchange rate</i>						
Nominal	- 1.5	+ 1.7	+ 1.2	- 3.2	- 0.1	- 1.5
Real	- 1.6	+ 2.0	+ 1.5	- 3.0	- 0.3	- 1.6

Source: WIFO. 2015 and 2016: forecast. – <sup>1</sup> 10-year central government bonds (benchmark).

#### **4. The risk environment**

The cyclical recovery projected for 2016 largely hinges on the assumption of a revival of trade and industrial output in the EU. Should this development, well argued by the cyclical recovery in the euro area and the significant depreciation of the euro, prove weaker than assumed here, the stagnation of the Austrian economy may extend into 2016. The credible pledge by the ECB to intervene in the event of crisis reduces the vulnerability of the euro area. The looming insolvency of the Greek government and the implicit drop-out from EMU would seriously undermine the political fabric of Monetary Union and threaten the economies in South-Eastern Europe, with negative repercussions for the Austrian economy.

A stronger cyclical upturn may materialise in 2016 should the tax reform be counter-financed to a lower degree than planned. However, in the event of the government deficit turning out higher, fiscal policy would have to become more restrictive in the following year, exerting a dampening effect on business activity. The initiative for higher investment in Europe launched by the European Commission ("Juncker-Plan") may stimulate private investment beyond what has been assumed in the present forecast.