WIFO
1030 WIEN, ARSENAL, OBJEKT 20
TEL. 798 26 01 • FAX 798 93 86

ÖSTERREICHISCHES INSTITUT FÜR WIRTSCHAFTSFORSCHUNG

Options for the Consolidation of Government Budget in Austria

Executive Summary

Karl Aiginger, Michael Böheim, Kristina Budimir, Norbert Gruber, Hans Pitlik, Margit Schratzenstaller, Ewald Walterskirchen

Research assistance: Dagmar Guttmann, Elisabeth Neppl-Oswald, Nora Popp, Andrea Sutrich

February 2010

WIFO

ÖSTERREICHISCHES INSTITUT FÜR WIRTSCHAFTSFORSCHUNG
AUSTRIAN INSTITUTE OF ECONOMIC RESEARCH

Options for the Consolidation of Government Budget in Austria

Executive Summary

Karl Aiginger, Michael Böheim, Kristina Budimir, Norbert Gruber, Hans Pitlik, Margit Schratzenstaller, Ewald Walterskirchen

February 2010

Austrian Institute of Economic Research

Internal review: Heinz Handler, Gunther Tichy
Research assistance: Dagmar Guttmann, Elisabeth Neppl-Oswald, Nora Popp, Andrea Sutrich

Abstract

Fiscal policy in Austria has dampened to an important extent the deep recession triggered by the financial and economic crisis of 2008-09 by deliberately accepting a further deterioration in the public debt position. At present, domestic and international projections suggest that the downturn has passed its trough and that demand and output are recovering gradually. Therefore, a consolidation of government budgets over the medium term has from now to be put on the policy agenda.

In its updated Stability Programme submitted in late January 2010, the Austrian government has outlined a consolidation path defining the scope and pace of the planned improvement in the general government balance: the deficit is to be reduced from 4.7 percent of GDP in the current year to 4 percent in 2011, 3.3 percent in 2012 and 2.7 percent in 2013. This path is ambitious, but realistic. It should be implemented in a way that does not put at risk the achievement of other economic policy objectives, but support them to the extent possible.

The shape of the consolidation process depends on strategic policy decisions, such as on the allocation of the burden among the different government levels, the relative weight of adjustment via the expenditure versus the revenue side, or the potential contribution from privatisation of public assets. This study sets out to present considerations and suggestions in this regard. These are intended to define the range of policy options for consolidation without leading to explicit recommendations, even if advantages and drawbacks are set against each other on the basis of the empirical record.

Please refer to: Karl.Aiginger@wifo.ac.at, Michael.Boeheim@wifo.ac.at, Kristina.Budimir@wifo.ac.at, Hans.Pitlik@wifo.ac.at, Margit.Schratzenstaller@wifo.ac.at, Ewald.Walterskirchen@wifo.ac.at

2010/180/S/WIFO project no: 7709

Medieninhaber (Verleger), Herausgeber und Hersteller: Österreichisches Institut für Wirtschaftsforschung,
1030 Wien, Arsenal, Objekt 20 • Tel. (+43 1) 798 26 01-0 • Fax (+43 1) 798 93 86 • http://www.wifo.ac.at/ • Verlags- und Herstellungsort: Wien

Verkaufspreis: 20,00 € • Kostenloser Download: http://www.wifo.ac.at/wwa/jsp/index.jsp?fid=23923&id=39722&typeid=8&display_mode=2

Options for the Consolidation of Government Budget in Austria

Karl Aiginger, Hans Pitlik, Margit Schratzenstaller

Executive Summary

Fiscal policy in Austria has dampened to an important extent the deep recession triggered by the financial and economic crisis of 2008/09 by deliberately accepting a further deterioration in the public debt position. At present, domestic and international projections suggest that the downturn has passed its trough and that demand and output are recovering gradually. Therefore, a consolidation of government budgets over the medium term has from now to be put on the policy agenda.

In its updated Stability Programme submitted in late January 2010, the Austrian government has outlined a consolidation path defining the scope and pace of the planned improvement in the general government balance: the deficit is to be reduced from 4.7 per cent of GDP in the current year to 4 per cent in 2011, 3.3 per cent in 2012 and 2.7 per cent in 2013. This path is ambitious, but realistic. It should be implemented in a way that does not put at risk the achievement of other economic policy objectives, but support them to the extent possible.

The shape of the consolidation process depends on strategic policy decisions, such as on the allocation of the burden among the different territorial authorities, the relative weight of adjustment via the expenditure versus the revenue side, or the potential contribution from privatisation of public assets. This study sets out to present considerations and suggestions in this regard. These are intended to define the range of policy options for consolidation without leading to explicit recommendations, even if advantages and drawbacks are set against each other on the basis of the empirical record.

1. Starting point: the need for consolidation and the economic context

Interest burden as alarming signal

(1) The necessity of fiscal consolidation is demonstrated most clearly by the weight of the interest burden. In 2009, Austrian public debt required € 7 ½ billion in interest expenditure; in the absence of consolidation, this amount would rise to a projected € 11 billion by 2013. Debt service cost matches about three-fourths of current Federal outlays on education (excluding higher education) and claims more than one-third of wage tax revenues. Without consolidation, interest payments would exceed education expenditure by 2013.

Legacies from the past and new challenges

(2) The need for consolidation derives not only from expenditure increases and tax revenue shortfalls resulting from the crisis. Already before the latest recession, the budget deficit, adjusted for cyclical variations, amounted to nearly 2 per cent of GDP. A balanced general government budget has never been achieved in the last 35 years. Moreover, new challenges such as globalisation, climate change, population ageing, education and new technologies, put new claims on public financial resources. These can only be financed if traditional government tasks are carried out more efficiently.

Economic growth as key requirement; the proviso of cyclical conditions

(3) The targets of the government's Stability Programme are ambitious, implying an annual consolidation requirement of around € 2 billion as from 2011. Even with such a trajectory, the government debt ratio would rise from currently 66.5 per cent to 74.3 per cent of GDP in 2013, as compared with a ratio of 78 ½ per cent in a scenario without consolidation. The effort that fiscal policy has to make in order to achieve the targets largely depends from the overall economic performance. On the basis of the WIFO forecast, the study assumes GDP growth in Austria at 1.5 per cent for 2010 and 1.8 per cent p.a. over the medium term. Each percent of nominal growth lowers the budget deficit by a couple of tenths of a percentage point, yielding a government debt-to-GDP ratio that is 5 percentage points lower in 2020 than in the baseline scenario. Should economic developments turn out significantly worse than assumed in the WIFO medium-term projections, the profile and target of consolidation need to be reconsidered (proviso of cyclical conditions).

The goal of regaining fiscal room for manoeuvre

(4) The ultimate objective of fiscal consolidation is not to reach a certain deficit figure or amount of savings, but the restoration of policy room for manoeuvre. Consolidation is not a purpose in itself, but a necessary condition for the achievement of economic policy goals. It should therefore be guided by a strategic vision for the Austrian economy in 2020. While being implemented, consolidation implies sacrifices which, if well communicated, credible and fairly distributed, may dampen growth and employment in the short term, but will on balance yield benefits in the long run.

Embedding into a comprehensive strategy

(5) Consolidation is not the only policy priority. The challenge of high and persistent unemployment, the achievement of climate goals, reform of the education system, social cohesion and integration of migrants, population ageing, reform of the financial sector and competitiveness in a global society are to be included into an overall economic policy strategy. The present study cannot cover all these aspects, and special analyses are

available for some of these areas (e.g. WIFO White Paper, study on options for taxation policy, thematic focus on the financial crisis), the options for consolidation should be included into the perspective of reaching these policy goals. The consolidation process should be designed in such a way as not to jeopardize, but rather promote the achievement of these goals.

2. Experience from earlier consolidation exercises

Criteria for successful consolidation: international and national evidence

(6) Empirical studies show that there are cases of successful sustained consolidation which had little or no negative short-term effect on growth and employment, but with a positive impact later on. Among these are notably experiences from Sweden, Finland and partly Belgium during the 1990s. Comprehensive studies which examine successful and non-successful consolidations across many countries and different periods show that consolidations from the expenditure side are more likely to be successful than those from the revenue side (since rapid growth of certain expenditure categories are a major reason for a recurrent necessity to consolidate). Severe crises and well-communicated programmes of fiscal retrenchment increase the chances for successful consolidation. The likelihood of success is also enhanced if expenditure cuts target the cost of administration and transfer payments rather than investment outlays.

The Austrian experience of fiscal consolidation during the 1990s is also encouraging. A cut in the deficit from 6 per cent to 2 per cent of GDP was achieved with virtually no negative effect on growth. Consumers and, to a lesser extent, companies changed their spending behaviour in such a way that in conjunction with a steady increase in foreign demand it offset lower government demand. The consolidation of 1996/97 was achieved by one-third via higher revenues and by two-thirds through lower expenditure, including also revenues from privatisation and outsourcing of government responsibilities. The economic environment was favourable in the 1990s, even if many European countries moved to fiscal restraint at the same time in order to meet the Maastricht criteria. Consolidation in 2001 relied more strongly on higher revenues, with the burden biased towards lower incomes, and entailed losses in terms of growth and employment.

Difficult framework conditions

(7) In comparison with previous instances, the framework conditions for consolidation appear much more complex in the years to come. All industrialised countries need to move towards fiscal restraint at the same time, while private consumption and investment recover only gradually from the crisis. Unemployment is high, and income maintenance is of particular importance in the post-crisis period, since the adverse social consequences of consolidation will add to those created by the crisis. On the other hand, there may be pent-up demand on

the part of both consumers and investors that should be gradually unwound as uncertainty subsides. Moreover, global demand is boosted by dynamic growth in Southeast Asia. At the same time, competitive pressure is high at the international level, due to substantial slack in productive capacities. While considerations of an EU strategy for economic policy during the period of consolidation are beyond the scope of this study, a pro-active follow-up of the Lisbon Strategy and the co-operation with accession candidates and countries in the EU neighbourhood remains important for consolidation in the Member States.

Proviso of cyclical conditions

(8) The recommendations for fiscal consolidation by the European Commission, the updated Austrian Stability Programme and the present study all expect the economic recovery to be moderate and labour markets to weaken further, with annual GDP growth rates projected at 1-2 per cent for Europe and 3 per cent on a global scale. Should cyclical developments turn out weaker, timing and scope of consolidation ought to be reviewed. In Austria and in Europe as a whole, programmes with strong impact on employment and positive external effects (qualification, environment) should be prepared, to be launched in case the recovery stalls.

3. The range of options and the active component

Consolidation primarily from the expenditure side, sparing social programmes

(9) The study presents options for the reduction of expenditure, the increase in current revenue and for receipts to be gained from asset sales. In principle, the choice among the different options is a political decision. However, experience suggests giving preference to the options addressing the expenditure side. Exploiting the potential for efficiency gains should be given top priority as these may yield early contributions to consolidation and restore the scope for policy action in the long run. Raising the efficiency of public spending is particularly important for Austria since the government expenditure ratio is above 50 per cent of GDP (2009) and rather high by international standards. A specific problem with consolidation from the expenditure side is that a large part of public spending benefits low-income groups. This advises in favour of a selective approach addressing areas of notional inefficiencies rather than applying linear cuts across all spending programmes. Labour market support, social security and transfers to private households should be largely exempt from consolidation, given widening income differentials and the repercussions of the crisis on individuals, even if it remains important to strengthen economic incentives and abolish privileges for certain groups that are difficult to justify.

Privatisation: potential for debt reduction

(10) Privatisation played a role in many consolidation strategies that proved successful; it should therefore be included into the design of the appropriate strategy. Sales of public assets lower the debt level and thereby annual debt service cost. In order to keep ideological aspects out of the strategy, privatisation should only go as far as to still leave decisions of strategic importance in the hands of the government (retaining stakes above 25 per cent or 50 per cent).

Revenue: structural improvement with positive consolidation effect

(11) The revenue-side options are ranked according to the results from international empirical studies (*inter alia* from the OECD) and the WIFO study on taxation, supplemented, on the basis of the experience of the financial market and economic crisis, by a financial transaction tax (or alternatives in case such a tax cannot be agreed upon at the European level). Resorting to revenue options with an impact on the distribution of income is also a political decision. From the economic perspective it would be an advantage to alleviate the burden of labour taxes over the medium term. If the abolition of tax exemptions, higher taxes on environmental emissions and other "public bads" and greater reliance on specific wealth taxes would yield a temporary contribution to consolidation, this would be helpful, notably in case that the options on the expenditure side prove unfeasible for political reasons. In the event, however, special care should be taken that the options selected do not weaken the already fragile demand of private consumption and investment.

Growth impetus: stimulus programme ahead of consolidation

(12) The moderate prospects for future growth and the great challenges ahead require that higher priority be given to measures conducive to sustained economic growth and job creation. Consolidation strategies typically include only restrictive measures during their implementation (an exception is Finland, which during the crisis of the early 1990s pressed ahead with the move towards a knowledge society). WIFO recommends for 2010, which by general consent is a year where economic activity still needs government support, a "stimulus programme" amounting to around € 1 billion. Such a programme should first, stabilise the labour market (such as via retraining of people with obsolete qualifications), second, create double dividends for job creation and energy saving (insulation of buildings) and third, finance reforms in education, pre-school care and research promotion. This could ensure that the economy has moved to a steeper growth path when consolidation starts. The stimulus programme could be financed via the abolition of outdated tax privileges (single-earner tax credit for people without children, tax rebate for overtime work, tax concession for the ex-post "purchase" of insurance periods to qualify for early retirement), and from unused allocations for past stimulus programmes. Yet, the new programme is not intended to counter

a cyclical weakness of demand and output, but to mobilise the potential for consumption and investment over the medium term.

Improvement of the structure of expenditure via a permanent „active component"

(13) Over the entire consolidation period, the budgetary savings should be accompanied by a permanent „active component". If the consolidation requirement is some € 2 billion per year, as pledged in the Stability Programme, the government should aim for a gross amount of € 3 billion (achieved through a combination of spending cuts, lower debt service cost due to receipts from asset sales and additional revenues), of which some € 1 billion could be spent on forward-looking investment. In this way, jobs could be created and competitiveness in terms of quality and technological advance (inter alia environmental technology) be strengthened. Compared with the expenditure cuts, investment into the growth potential has a higher impact on output, income and jobs (expenditure composition effect).

4. The options in detail: exploit potential savings in government expenditure

Opportunities for saving on the expenditure side ought to be used

(14) International comparisons suggest that the potential for savings in government spending is large in Austria. Total government expenditure in relation to GDP is higher by 2 ½ percentage points than in the EU-15, and by 6 percentage points than in the EU-27/OECD area, corresponding to nominal amounts of € 8 billion and € 17 billion, respectively. Nevertheless, expenditure cuts should not be applied at a constant rate across the board, since first, the composition of expenditure is also a reflection of political priorities, second, there are structural reasons for existing (above-average) spending amounts and third, since many expenditure items are to the very benefit of low income earners. The international comparison shows that in Austria especially subsidies (including support for public and quasi-public enterprises), monetary transfers to private households and health expenditure are rather high.

Administration: potential for savings limited in the short run, but much higher in a longer perspective

(15) In the area of public administration, some opportunities for cost reduction may be used within short time, but others will materialise only in the longer term. Partial or full non-replacement of staff leaving the service, lower wage settlements, co-ordination of procurement policies between the Federal and lower levels of government or via co-operation between local authorities may be implemented at short notice. The potential for such savings of personnel and material cost is estimated within a range from € 200 million up to € 1.1 billion, depending on whether on to what extent there will be exemptions for certain services. The scope for savings in the long run is assessed with regard to benchmarks of

successful practices in other countries, taking into account structural differences. Implementation requires institutional reform (review of tasks, personnel statutes and salary scales, federal fiscal relations and burden sharing) and new incentive and control mechanisms in public administration. The long-term potential contribution to consolidation is estimated at up to € 2 ½ billion.

Subsidies: Strategic alignment and cuts to match the international level

(16) A reduction of corporate subsidies to the average European level would arithmetically yield savings of € 9 billion per year. If one excludes the health care sector (for which potential savings are calculated separately), research subsidies (where there is scope for higher efficiency, but also a greater effort required to reach higher benchmarks) and labour market support[1], there still remains (adjusted for structural factors) an amount of € 3 ½ to 5 billion that Austria spends more than other countries. However, a reduction of subsidies should be subject to an ex-ante evaluation and impact assessment, e.g. for public transport or regional development. If one estimates the margin for greater efficiency of public subsidies at 10 per cent, potential short-term savings would amount to € 850 million, which would still leave the level of subsidies in Austria far above the international average. Applying linear cuts across all subsidies disregarding political priorities would not be optimal from an economic point of view. Cuts should be applied on the basis of prior evaluation and with a view to the goals to be achieved by each individual subsidy.

Health care: raising efficiency without loss in quality

(17) The increase in expenditure of the health care system is not caused by rising needs (e.g. population ageing), but by an intransparent allocation of responsibilities and complex financing structures as well as a lack of co-ordination between the parties involved, leading inter alia to an excess supply of hospitals and beds or to the duplication of services. The contribution of the health care sector to fiscal consolidation, estimated on the basis of the numerous studies available, amounts to € 300 million per year in the short term and to € 2 - 3 billion in a longer-term perspective.

Social welfare system: no cuts in core programmes

(18) Despite its large share of total government spending, the area of social transfers and labour market support is not a focal point of proposed cuts, since it ranks high on the agenda of political priorities and given the broad consensus in Austria of the social system being a productive factor that strengthens both economic performance and social cohesion. Nevertheless, regulations for special groups in this area should be reviewed or terminated,

---

[1] Although one may expect that also this area offers scope for raising efficiency in the longer run, immediate cuts in spending in the present still fragile recovery are not deemed advisable, given the implicit negative repercussions for particularly vulnerable groups of the labour force.

notably those with a negative impact on labour force participation. Reform of the rules governing pension rights of people having accumulated long insurance periods, partial retirement, the ex-post "purchase" of insurance periods, the contribution-free insurance of family members with no obligation to care for children or handicapped family members may yield savings up to € ½ billion without cutting into core services. Not included are long-term savings that may be achieved if the effective retirement age were to converge towards the statutory age.

Overall savings: € 2-3 billion in the short term, up to € 11 billion in the long run

(19) The options on the expenditure side generate potential savings of € 2-3 billion in the short term and of € 6 ½ - 11 billion per year in the long run. The latter can, however be obtained only by way of a number of major reforms. Every successful consolidation must be accompanied by strategies to keep the trend of rising expenditure under firm control. Among these are technological leadership in the areas of environmental protection and energy supply, health care, experience rating in unemployment and health insurance, adaptation of workplaces to older workers, controlling for large-scale public investment.

5. The options in detail: potential contribution from privatisation

Public ownership is only one possible form of governance

(20) Results from public asset sales (privatisation) may help to reduce the level of government debt and narrow current deficits via lower interest payments. If the government were to retain a strategic majority in all hitherto publicly-owned enterprises, it could still expect privatisation revenues between € 8 billion (cautious estimate with 50 per cent public ownership, e.g. in electricity companies) and € 25 billion (if the government keeps only a blocking minority of 25 per cent plus 1 share). Apart from the electricity companies, this would imply a reduction in government stakes in the three remaining large enterprises as well as partial privatisation of the Federal Real Estate Agency (BIG) and the Federal Forests. The receipts from these privatisations would lower the annual debt service cost within a range from € 300 million up to € 1 billion. Privatisation should be carried out without setting an ex-ante time frame and with due consideration of the purpose attached to public ownership (e.g. regulation, obligation of universal service coverage).

6. The options in detail: contribution to consolidation and structural effect of taxes

Employment-friendly tax system potentially generating additional revenue

(21) For the revenue side, the study recalls proposals already included in the WIFO study on options for taxation (published in 2008) for the improvement of the revenue structure, in order

to make the tax system conducive to higher growth and employment, and to limit the widening differentials in personal income and wealth. Among these proposals are the reduction of tax privileges, greater reliance on taxes on real estate, inheritance and wealth increases, as well as taxes yielding a "double dividend" (on emissions , tobacco, alcohol, gambling). Potential revenues from such taxes add up to almost € 2 ½ billion. This amount may be supplemented or partly substituted by revenues from a financial transaction tax possibly introduced at the European level (or an equivalent, likewise internationally co-ordinated), or by taxes of stronger redistributive impact if politically desired. Increases in VAT or in social contributions, which would be the options with the highest potential revenues, are nevertheless not recommended, for distributional reasons, but also in order not to jeopardise the recovery of private consumption or exacerbate the problem of unemployment. The from the perspective of growth and jobs less problematic tax increases should be used to reduce over the medium term the high tax burden on labour, notably for the lower income brackets.

7. Macro-economic design of consolidation

Consumption, investment and exports are to replace government demand

(22) Budgetary consolidation may have negative short-term effects on the labour market. In the longer run, however, the advantages of policy room for manoeuvre and competitiveness having been restored will lead to brighter employment perspectives. The present study intends to show a way how to limit or even avoid any adverse effects: first, through the stimulus programme, second via the "active component", where expenditure should have higher multiplier and employment effects than the savings, and third through an employment-friendlier tax composition. The consolidation-induced shortfall in government demand is to be compensated by other demand components. This would be achieved, if the private household saving ratio were to decline from its high level, if investment could make up at least part of its slump of 2009, or if the trade balance would swing back towards surplus, e.g. through higher exports to Asia. In order to stimulate these demand components, mainly such options have been advanced which would dampen private saving rather than consumption, are deemed investment- and employment-friendly and do not compromise external competitiveness.

The challenge needs to be met and opens up encouraging perspectives

(23) Given current economic prospects, the task of consolidation can be accomplished. Should economic developments turn out significantly weaker (falling short of the medium-term WIFO projections), the strategy ought to be re-assessed and, if necessary, moderated or postponed, or the active component be strengthened. The annual targets to achieve the final consolidation objective defined by the Federal government can be reached through a well-defined and politically agreed strategy. The options presented for expenditure reduction

as well as those for revenue increases exceed by far the amount of consolidation required and should be used also for structural reform. Consolidation should take into account also the other goals of economic policy and support them in a medium-term perspective. Consolidation is a necessary condition for the margin of manoeuvre of economic policy to be restored. The choice among the different options, and in particular the implementation of the strategy are core tasks for economic policy going forward.