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The Financial Market Crisis and Budget Policy

In the coming years we expect high public deficits, largely due to the effects of the financial and economic crisis. For at least five years, the budget plan drawn up in the 2009 to 2013 Austrian Stability Programme projects net state borrowings exceeding the Maastricht limit of 3 percent of GDP. Potential for a consolidation of public budgets can mainly be found on the expenditure side, while there is little room increasing revenues.

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The global financial market and economic crisis will influence the budget path for some years to come. Since autumn 2008, the greatest challenge in budget policy was to soften the effects of the crisis on the real economy. To this end, a worsening of the public deficit position had to be accepted. The decline of cyclical tax and social security contributions and the consequences of rising unemployment have substantially burdened the budgets of industrialised countries. Discretionary stimulus programmes, which have also contributed to stabilising growth and employment, have further increased government deficit and debt.

Additionally, various support measures for banks have an immediate effect on public debt (e.g., participatory capital) and may result in future budget constraints (government guarantees for bank emissions). As early as September 2009, the European Commission requested that the member states prepare a strategy for the reduction of debt by the end of 2009. In October 2009, the European finance ministers agreed to implement consolidation measures in 2011, provided economic development had stabilised. In the context of future consolidation, fiscal requirements have to be reconciled with both short-term stabilisation policies and general distributional concerns.

Budget policy before and after the crisis

According to the base scenario of the updated stability programme for 2009 for 2013, the Maastricht deficit for the general government increases from 0.4 percent of GDP in 2008 to 3.5 percent of GDP in 2009[1]. In 2010 and the following years it is projected to reach 4.7 percent of GDP and only decline slightly to 3.9 percent of GDP by 2013. For at least five years the implied path of public finances therefore forecasts net state borrowings that lie significantly above the Maastricht limit of 3 percent of GDP. However, from today's perspective, the forecasts presented in spring appear to have been overly optimistic. Based on the budgetary notification from the end of September, the federal finance ministry anticipates a budget deficit of 3.9 percent for this year, while the International Monetary Fund and the European Commission, respectively, expect the deficit to reach 4.2 percent and 4.3 percent of GDP. WIFO has forecast a budget deficit of 4.2 percent, which may increase to as much as 5.2 percent of GDP in 2010.

[1] The article was completed in the end of November 2009 and thus before the publication of the updated stability programme of January 2010.

The fiscal development expected in the coming years can be largely attributed to the budgetary effects of the financial crisis. Austria has set up a package of measures to stabilise the financial market and responded to the drastic deterioration of economic prospects by means of active discretionary measures to revitalise the economy (early implementation of the tax reform initially planned for 2010, economic stimulus packages I and II, economic stimulus packages of the states. Automatic reductions of public revenue and increases on the expenditure side (in particular the cyclical loss in tax income and the increased spending on unemployment benefits and social welfare) have generated significant additional budgetary costs. Cumulatively, for the years 2009-10, the measures to revitalise the economy will amount to € 11.9 billion (4.2 percent of GDP). However, these will not burden the public budget exclusively or partly merely indirectly, such as, for example, in the case of the infrastructure investments of extra-budgetary companies (ASFINAG, BIG, ÖBB).

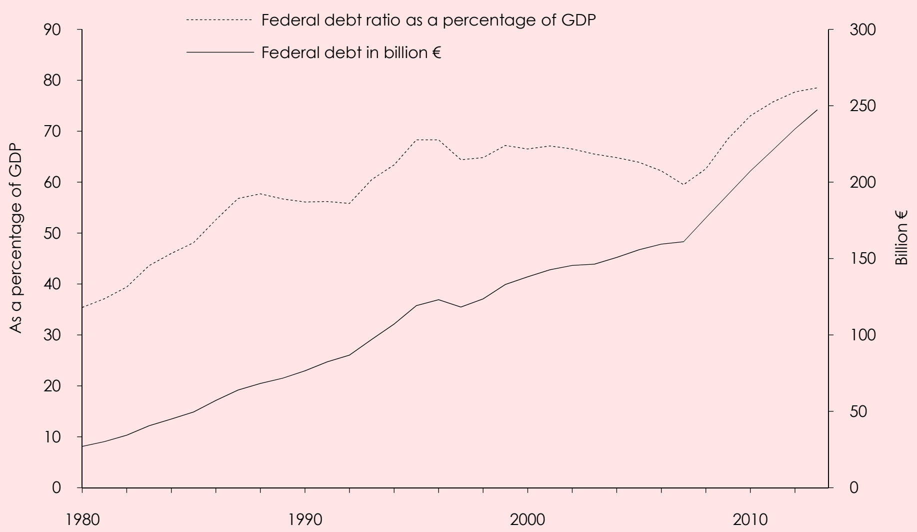
In light of the depth and feared duration of the recession, most economists advocate a massive temporary demand stimulus in order to limit the real economic collapse. The current downturn is so serious that a temporary surpassing of the Maastricht deficit limit is considered sensible. Of course, the fiscal package should primarily consist of temporary expenditures, especially with respect to investments that stimulate long-term growth. Due to the uncertainty of households and businesses, general tax cuts may only have a weak effect in the short term, with delayed positive effects on consumption and investments.

About half of the expansionary measures in Austria consist of permanent tax cuts, whose short-term effectiveness in the crisis is supposed to be limited. The economic stimulus packages put the focus on material infrastructure, with much less emphasis placed on intangible investments in research and education, which are particularly important to fostering future growth prospects. In 2009 and 2010, based on WIFO macro model simulations (*Breuss – Kaniovski – Schratzenstaller,* 2009), Austria's real GDP is expected to cumulatively increase by 2.1 percent and the number of employees is expected to increase by 41,500 as a result of the federal and state economic stimulus packages, the early implementation of the tax reform and the spillover effects of the economic stimulus packages of Austria's ten most important trade partners.

According to the stability programme, the gross deficit, which dropped below 60 percent of GDP for the first time in 2007 at € 161 billion, is expected to increase to 78.5 percent of GDP (€ 247.3 billion) by 2013. A more sceptical growth outlook forecasts that the deficit will increase to significantly above 80 percent of GDP. As a direct result of the increasing debt, the interest burden of public households and social security institutions will rise from 2.6 percent of GDP in 2009 to 3.6 percent of GDP in 2013. The future scope of budgetary actions will be significantly impaired due to the deficit and the rising interest payments. Potential risks from state guarantees have not been included, nor has the financial debt of the extra-budgetary infrastructure companies, which collectively amounted to € 32 billion or approximately 11 percent of Austria's GDP output in 2010. Of the package of measures to secure and stabilise the financial market agreed on in October 2008, a large portion (up to € 75 billion) consists of guarantees for the emissions of banks (up to € 65 billion) and firms (up to € 10 billion), as well as deposit insurance for individuals (up to € 10 billion), which will only burden the public budgets if they go into effect. The budget includes € 10.8 billion (about 3.5 percent of GDP in 2013) for the provision of participatory capital and the purchase of government shares in banking institutions. The debt ratio would therefore increase correspondingly.

For over 30 years, Austria has registered a clear rise in its public debt figures (Figure 1). In absolute figures, government debt only slightly declined in 1997, primarily as a result of spin-offs (formal privatisations) from the budget. The debt increase was particularly high in relation to the economy from the early 1980s and early 1990s. The moderate success of consolidation efforts since 2000 will of course not be offset solely by the financial crisis and the predicted slow economic growth after the crisis. Expenditure and revenue measures put in place in the spring of 2008 will also contribute to the worsening of the state deficit situation. Permanent and partly increasing budgetary costs (up to 0.6 percent of GDP by 2013) are due in particular to legislation passed by the Austrian parliament on 24 September, 2008, shortly before the last parliamentary election, as well as to the "anti-inflation package" passed in the spring of 2008 (2013: 0.1 percent of GDP). Beyond this, additional expenditures over the past years in the areas of nursing (elderly care), pensions and families will also have an effect, as will ongoing structural reforms (*Staatsschuldenausschuss/Government Debt Committee*, 2009).

Figure 1: Austria's federal debt since 1980



Source: Statistics Austria, Federal Ministry of Finance. 2010 to 2013: Forecast based on the stability programme.

Consolidation policy after the crisis

The exact need for consolidation in the public budget cannot be "objectively" quantified. The volume of the measures depends on the budgetary targets on the one hand, and on the other hand on the timeframe in which these targets are to be reached. Based on WIFO calculations, depending on which goal has been set for the period between 2011 and 2013, the need for consolidation is estimated to range from between € 5 and 56 billion (Table 1). However, it is generally agreed that an austerity programme should not be launched in 2010, in order to prevent contractionary effects on the slowly recovering economy.

Table 1: Consolidation volumes and development of the debt ratio for alternative targets

	Consolidation volume				Debt ratio		
	2011	2012	2013	2011-2013	2011	2012	2013
	Billion €				As a percentage of GDP		
Reduction of the debt ratio to 60 percent of GDP by 2013[1]		15.5 to 18.8 p. a.[2]			46.4 to 56.4[2]		60.0
Reduction of the structural deficit by 0,5 percentage points p.a.[1]	1.5	1.5	1.6	4.6	75.2	76.7	77.0
Reduction of the deficit to 3 percent of GDP by 2013	2.2	2.3	2.4	6.9	76.3	77.5	77.4
Reduction of the deficit to 2.9 percent of GDP by 2012[1]	–	5.4	3.1	8.5	75.7	75.9	75.7
Reduction of the structural deficit by 1 percentage point p.a.[1]	2.9	3.0	3.1	9.0	74.7	75.7	75.5
Maximum deficit respectively 3 percent of GDP[1]	5.0	5.1	2.8	12.9	74.0	74.3	74.2
Elimination of structural deficit[1]	10.8	11.5	10.4	32.7	72.0	70.2	67.7

Source: WIFO. – [1] Basis: forecast of the Federal Ministry of Finance. – [2] Lower value under the assumption of a complete return of recapitalisation measures for banks. – [3] Forecast of the European Commission for 2011: 5.3 percent of the GDP.

Once the economy starts to grow, the cyclical recovery of tax revenues and reductions in expenditures can be used to reduce the deficit. Moderate relief effects will also appear if revenues are gained from the participatory capital and guarantee fees which have been made available. The recent past has shown, however, that even unexpectedly high tax revenues, for example those observed in the years 2006 to 2008, are largely used to increase spending and rarely to consolidate the budget. The target of a balanced budget through the economic cycle would have required a positive general government balance by 2008 at the latest.

Against the backdrop of high debt levels set to rise in the long term as a result of increased deficits and due to demographically-related expenditures effects (health, nursing, pensions), it appears all the more urgent to find an appropriate strategy to balance the budget after the crisis. Empirical studies on consolidation in OECD countries clearly show that policies based on tax increases yield only minimal or temporary success. However, a reduction of expenditures, in particular for administration and transfers (social spending and subsidies) has a sustainable effect on budget consolidation, as it addresses the source of public debt dynamics (*von Hagen – Hughes-Hallet – Strauch*, 2002, *Wagschal – Wenzelburger*, 2008). A current WIFO study (*Pitlik et al.*, 2008) shows that in Austria the potential for expenditure-based consolidation is high.

The structure of government spending in Austria differs from that of the other EU-15 countries, primarily due to Austria's higher than average share of monetary social transfers, which reached 18.1 percent of GDP in 2008, compared to the EU-15 average of 14.8 percent (Table 2). Including social transfers in kind (primarily in the health care system) of 5.5 percent and other transfers of 2.1 percent of GDP, transfers to private households amounted to 25.7 percent of GDP – almost 5 percentage points higher than the average of the EU-15 countries (excluding Austria). A total of 5.7 percent of GDP was spent on subsidies and capital transfers, also one of the highest values within the EU. At the same time, little is known about the efficiency and effectiveness of the spectrum of social benefits and subsidies. Essentially, savings should be realised through the identification and elimination of inefficiencies, not through spending cuts. Intended objectives and effects are frequently not explicitly stated by policy makers, and it is therefore difficult to assess and evaluate the effects of policy measures. At least the federal government has appointed a "Consolidation Committee" to examine the effectiveness of Austria's subsidy system.

Table 2: Spending structure in Austria based on economic criteria in international comparison 2008

Spending category	EU 15[1]	Austria
	As a percentage of GDP	
Production costs	17.8	13.7
Personnel costs	11.4	9.2
Intermediate consumption	6.4	4.6
Transfers to private households	20.8	25.7
Social benefits in kind	3.8	5.5
Monetary social transfers	14.8	18.1
Other current transfers	2.2	2.1
Transfers to firms	2.4	5.7
Subsidies	1.2	3.6
Capital transfers	1.2	2.1
Gross investments	2.8	1.1
Interest	2.4	2.6
Total expenditures	46.4	48.9

Source: OECD, Eurostat, WIFO calculations. – [1] Excluding Austria.

Compensation of employees and intermediate consumption expenditures for the entire government sector lie below the average of the EU-15 countries, reaching 13.7 percent of GDP. The notion of a bloated public administration is therefore not confirmed in international figures. However, numerous extra-budgetary entities in Austria distort a cross-country comparison. A more narrow view, influenced less by budget spin-offs, is confined to expenditures for legislative or executive bodies, the financial and fiscal system, external affairs, international economic aid and general public services (human resources management, statistical services). According to recent WIFO studies (*Pitlik et al.*, 2008, *Pasterniak – Pitlik*, 2008), Austria has a comparably expensive general public administration. With respect to reference countries of a similar size, such as Denmark or Ireland, Austria's administration shows a medium to long-term theoretical efficiency reserve of € ¾ to 2½ billion.

Sustainable savings can only be achieved through comprehensive federal, fiscal and administrative reform (*Pitlik et al.*, 2009). Reforms should therefore not be primarily aimed at short-term savings opportunities, but rather at institutional incentives for creating and managing policies to provide public services with maximum efficiency. The separation of powers between the federal, state and local authorities, the consolidation of task, spending and financing responsibilities and the strengthening of the revenue autonomy of regions and municipalities should therefore take the highest priority. Decentralisation and administrative control over impact targets, competition between jurisdictions through institutionalised benchmarking or voucher systems not only promote transparency, but strengthen innovation and expose efficiency reserves in the public sector. Without institutional regulatory reforms, permanent consolidation gains cannot be expected.

With respect to revenues, the potential for consolidation is comparatively limited. First of all, based on the autumn forecast of the European Commission, the Austrian tax rate will still be relatively high in 2010, reaching 41.6 percent of GDP, and still significantly above the average of the EU-15 countries (38.5 percent of GDP) as well as that of the EU 27 (38.2 percent of GDP). Second, a tax increase during the crisis or at the beginning of the recovery would be counterproductive, especially considering that the tax reform initially planned for 2010 was implemented early and its economic impulses still need to unfold. In addition to this, a premature step toward tax increases in an effort to consolidate the budget would take the pressure off the government and administration to implement rigorous and comprehensive long-term reforms, which should (also) yield long-term savings. In the area of taxes and social security contributions, this primarily concerns the long-overdue reform of tax structures, which should lead to a revenue-neutral decrease of the unusually high tax burden on labour in Austria.

It is therefore necessary to address efficiency reserves in the area of expenditures first. However, if the consolidation targets cannot be achieved solely through measures on the expenditure side, then additional revenues could come from tax increases subsequent to successful consolidation, with the goal of financing a reduction of labour-related taxes. At the same time, because of unfavourable effects on employment and distribution, this should not involve an increase in mass taxes such as value added tax or social security contributions. Instead, there is a broad menu to choose from, which includes a reduction of tax exemptions, the introduction or raising of taxes on environmental and energy consumption or socially undesirable activities (such as tobacco, alcohol and gambling) and taxes on wealth.

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The Financial Market Crisis and Budget Policy – Summary

The budget plan drawn up in the Austrian Stability Programme 2009-2013 projects government net borrowing above the Maastricht limit of 3 percent of GDP for at least five years. The debt ratio will rise from just below 60 percent of GDP in 2008 to almost 80 percent of GDP in 2013. Fiscal developments expected for the coming years can largely be attributed to the effects of the financial and economic crisis. Austria adopted a set of measures to stabilise the financial market and responded to the drastic worsening of the economic outlook with active discretionary economic stimulus measures. The shortfall in cyclical tax revenues and social contributions as well as additional spending on unemployment benefits and social welfare generate substantial additional budgetary costs.

Against the background of long-term budgetary strain due to an increasing debt service and expenditure growth caused by demographic change, the issue of an appropriate consolidation strategy as soon as the crisis is overcome is getting all the more urgent. At the same time there is a consensus that the implementation of any austerity programme should not begin as early as in 2010 to avoid contractionary effects on a slowly recovering economy. Empirical studies of consolidation experiences in OECD countries show clearly that the success of policies relying on tax hikes is typically small or short-lived. A reduction of expenditures, particularly on administration and transfers (social spending and subsidies) has a more lasting effect on the consolidation of the budget, because it addresses the causes of debt growth. A WIFO study shows that the potential for an expenditure-based consolidation is likely to be high in Austria. In principle potential savings should not be achieved via general spending cuts, but rather via the identification and elimination of inefficiencies. Lasting success can only be achieved by a comprehensive constitutional reform of the federal state, accompanied by reforms of the fiscal equalisation scheme and public administration reforms.

On the revenue side, by contrast, the scope for consolidation is rather limited. If consolidation objectives cannot be met by means of spending cuts tax increases should not be precluded completely. However, mass taxes such as the VAT or social contributions should not be raised due to their unfavourable effects on employment and distribution. Instead, there is a wide choice among reductions of tax exemptions, an introduction or increase of taxes on the use of the environmental resources and energy as well as taxes on socially undesirable activities (consumption of tobacco and alcohol, gambling), and wealth taxes. Tax increases should, however, predominantly be used for a reduction of the labour tax burden after a successful consolidation.