

Assessment and recommendations

Austria has been affected by the international crisis...

Austria's economic expansion came to a halt with the global financial crisis which erupted in the summer of 2007 and intensified in the autumn of 2008. However, till end-2008, the downturn proved less abrupt than in most other high-income euro area countries. Private consumption and investment held up better, as did exports, notably to Central and Eastern Europe (CEE). International contagion first took the form of general tensions in the financing of banks and a tightening of economy-wide credit conditions. In response, the authorities put in place measures to bolster banks' liquidity and capital, and the confidence of depositors and creditors. The ongoing slump in world trade is the second channel through which global weakness is affecting Austria, where exports amount to some 60% of GDP. Coupled with the financial-sector uncertainties, and with the expectation of shrinking domestic employment, this foreshadows subdued spending by households and enterprises. Against this backdrop, and despite significant policy action, Austria is projected to experience its deepest and most protracted recession since the mid-1950s, with unemployment rising sharply, albeit with a lag.

... and is exposed to risks in Central and Eastern Europe

The financial system has been less affected than elsewhere, being less exposed to the most toxic international asset classes or to souring domestic credits. Strains arose in February 2009, however, when the perceived riskiness of credit positions in a number of CEE countries rose sharply in light of a deteriorating economic outlook and balance of payments problems. Austrian banks have been very active across a broad spectrum of countries in the region in recent years through cross-border loans and credits by subsidiaries, which accounted for a prominent portion of their total earnings. With Austrian banks' assets in CEE representing over 60% of Austrian GDP, the fiscal implications of a potential banking crisis raised concerns and the risk premium on Austrian government bonds soared to as much as 130 basis points in early 2009, though it has edged down since. Uncertainty about the situation in certain CEE countries endures, however, and deep recessions in the region would put additional strains on Austria's financial system, regional trade and domestic activity and investment. The ensuing risks differ across the CEE countries, however, both because of large differences in economic conditions there and as a function of their relative importance to Austria as economic partners.

A number of policy measures have been taken in response to the crisis

A series of monetary, financial, fiscal and labour market policy measures have been put in place since last autumn.

- In addition to the monetary stimulus imparted by the Eurosystem, the Austrian authorities have introduced a € 100 billion (36% of GDP) package, including a top-up of the deposit guarantee scheme by € 10 billion, € 15 billion for capital injections in financial institutions, and € 75 billion for supporting interbank lending (via a new clearing bank) and for government guarantees of bank bond issuance. Banks soliciting these resources need to sign agreements with the authorities and to step up lending. A new guarantee scheme underwrites the borrowings of small-and-medium sized enterprises for their investment and working capital needs. These measures have helped alleviate the strongest sources of tension in the financial system between October 2008 and April 2009.
- Fiscal policy has also responded to the exceptional circumstances. As the share of taxes and public spending in GDP is high, and as social transfers are comprehensive in Austria, the automatic stabilisers play a particularly large role. Moreover, discretionary stimulus is being injected, notably through measures to support households' purchasing power (including increases in family benefits, cancellation of student fees, and VAT cuts on medication), personal income tax cuts (brought forward from 2010 to 2009) and other measures such as new infrastructure investments. The fiscal deficit is projected to rise from close to zero to about 4.5% of GDP in 2009 – with approximately two thirds of the increase a result of automatic stabilisers and one third stemming from discretionary stimulus.
- Labour market policy action has also been taken. In Austria, workers' incomes are well protected in case of unemployment, initially through unemployment insurance and then through equally supportive social assistance. All recipients of unemployment insurance and social assistance are in principle referred to active labour market programmes, which seek to assess and, if possible, adapt their labour market skills. More recently, a rarely-used public subsidisation scheme for enterprises that keep on their employees despite falls in activity has been expanded. It is now available for up to 18 months, and compensates income losses due to working time reductions of up to 90% of the basic salary. Participating firms are encouraged to use the subsidised hours for re-qualification and retraining. Some 50 000 workers had been covered by this measure by April 2009 and the total take-up is expected to approach 70 000 by end-2009, amounting to a quarter of the current number of registered unemployed.

More may be needed, but without creating distortions

These various policy levers should continue to be used in a timely and flexible way, keeping in mind the need to avoid lasting negative side effects and to start phasing out policy support once economic conditions improve. Generous income maintenance is in principle associated with programmes aiming at improving recipients' employability and *care should be taken that they keep fulfilling that role through the crisis*. Neither the recent tax cuts nor

social protection appear to unduly distort market signals or hinder the adjustment of corporate structures and worker qualifications and it is essential that further measures – if any – also be as neutral as possible in that respect. Measures aimed at securing financial stability appear broadly effective to date, but further support may become necessary in the event of additional regional or global shocks. Plans should be ready in the event that the financial crisis worsens in one or more CEE countries. The Austrian authorities are closely monitoring developments. They have actively facilitated confidence-building and crisis-management contacts within the CEE region and the international financial community, and are keeping in close touch with their relevant counterparts. Depending on developments, further cross-border initiatives may be called for.

Austria has made a welcome step forward in tax co-operation

In response to the changing environment Austria has endorsed the OECD standard for the exchange of information in tax matters, and withdrew its earlier reservation on the applicable article in the OECD Model Tax Convention. Once information exchange consistent with the OECD Model is implemented, Austria will be in a position to exchange information on all tax matters foreseeably relevant for the administration or enforcement of the domestic law of its treaty partners. Austria is encouraged to implement this decision as rapidly as possible.

Fiscal sustainability needs to be safeguarded

The deterioration in Austria's fiscal position, though less dramatic than in a number of other OECD countries, is substantial and unavoidable. Going forward, however, the long-term sustainability of public finances should be ensured, not least because it conditions the short-term effectiveness of macroeconomic stimulus. Therefore, it is important to spell soon out a credible path of fiscal consolidation to be embarked upon once the recession has ended, based principally on expenditure restraint but also, if necessary, on increases in less distortive taxes. Two factors should play a positive role in this regard. First, the recent introduction of rolling four-year spending ceilings (which allow for cyclical spending on unemployment insurance and social protection) should help contain spending. Secondly, Austria has made progress with respect to containing ageing-related expenditure, especially on pensions. Nevertheless, efforts on this front should be maintained as risks and uncertainties remain high. Pension schemes for all civil servants should be fully harmonised, incentives for early retirement should be curtailed, disability pension schemes should be redesigned, a new sustainability mechanism for the pension system should be envisaged and health reforms should be implemented more resolutely.

Reform of fiscal institutions should help post-crisis consolidation

Before the onset of the recession, Austria had launched important fiscal institutional reforms. Strategic public expenditure planning and output-based budgeting are to be enforced from 2013. They involve explicit performance targets for all key public services, facilitating the assessment of the costs of public activities against their social benefits.

Such progress with transparency should help reveal areas where resources can be utilised more efficiently. Combined with a desirable – albeit admittedly difficult – reform of federal fiscal relations, *improved transparency of the costs and benefits of the Länder's activities would generate savings*. Indeed, as confirmed by a recent report of the Court of Audit, there is ample scope for savings in sub-central expenditures. Efforts at reforming federal fiscal relations, with an aim to better match service (spending) and funding (tax) responsibilities at federal and *Länder* levels will provide an occasion to re-assess and reform the structure of taxation. It should notably help promote the economically desirable, but so far elusive shift from a “work and income-based” to a more “wealth and consumption-based” tax structure. *A re-appraisal of the tax system should look at all of these issues.*

Growth potential can be lifted further

While the macroeconomic policy response to the global financial crisis is the immediate priority, it should not detract from structural reforms in product and labour markets. Austria continues to enjoy a relatively high level of GDP *per capita*, but over the past decade and a half it has tended to lose some ground compared with the front-runners. This reflects persisting gaps in both labour productivity and labour utilisation. The productivity gap has started to narrow in recent years, but the labour utilisation gap has tended to worsen. The most globally-oriented parts of the business sector have intensified their innovative efforts and achieved significant productivity gains, but the more sheltered services have been less dynamic. *Structural reforms and policies to improve productivity, investment and employment would not only help boost growth potential and average per capita income, but would also enhance social cohesion.*

Service market regulation should become more supportive of innovation and investment

Despite important liberalisation initiatives in recent years in large sectors such as retail trade and telecommunications, the regulatory framework in services remains somewhat restrictive. In the absence of the incentives and disciplines of trade competition, the rules governing market entry and the creation of new corporations, as well as various sectoral regulations, are not sufficiently supportive of competition, innovation and productivity growth. This is a prime factor underpinning the contrast between the good productivity and employment performance of manufacturing and a generally weaker record of services in international comparison over the past decade. Even though the legal framework of competition is strong and comprehensive – with few sectoral exemptions – competition policy will have to be fostered, especially by further strengthening the Federal Competition Authority (FCA). *Regulations should be adapted to instil more competition in trade-sheltered markets and facilitate entry, innovation and investment. The FCA should be mandated and adequately resourced to play a more proactive competition advocacy role.*

Greater competition is needed in the infrastructure sectors

Greater competition in network sectors such as energy, transport and communications would improve real incomes and the overall competitiveness of the economy. These

industries are characterised by large vertically-integrated firms with high government ownership relative to other OECD countries. Government ownership seems to enjoy broad public support as a source of quality and security of supply in key services, but cost and price performance fall short of OECD benchmarks. For example, electricity prices for industry exceed OECD averages and, while fees in telecommunication services are lower than OECD averages, they remain higher than in other high-income European countries. *Sectoral regulators and the FCA should closely monitor market structures, behaviour and prices in particular in electricity, gas, rail passenger transportation, postal services and telecommunications.*

Labour market dualism should be reduced

Austria's overall labour market performance is strong, with a high employment rate and a low unemployment rate – notwithstanding the recent rise in joblessness. At the same time, there is a stark contrast between the respective employment rates of a large, well-performing core of prime-age workers with at least upper secondary education, and vulnerable groups such as older workers and workers with less than upper secondary education. Among high-income OECD countries this contrast appears strong in Austria, and constitutes a drag on potential growth. The employment challenges faced by vulnerable workers may further increase in the future due to the inflows of workers from neighbouring countries after the full liberalisation of labour movements with the new EU member states in 2011. *Increasing the employment rate of older and low-skilled workers should be higher on the agenda, by addressing their remaining incentives for staying out of the labour force, as well as the impediments to stronger demand for their labour in the business sector. Helping up-skill these workers and improving their employability should also be a prime objective of public policies.*

The employment rate of older workers can be raised

The low employment rate of older workers mainly reflects their massive withdrawal from the labour force until a few years ago. Pension, early retirement and disability schemes provided them with incentives to do so. The associated benefit conditions have since been tightened but cumulative cohort effects persist. Moreover, some recent policy measures have weakened older workers' participation incentives. The penalty on early retirement was reduced in 2007, with a cut in the heretofore actuarially neutral discount rates applicable at early retirement. *To lift the employment rate of older workers, the early retirement and disability pension schemes should be redesigned. The discount rates applicable before the standard retirement age should be actuarially neutral.*

The low-skilled's work incentives should be strengthened

The employment rate of the low-skilled remains one of the lowest among high-income OECD countries. This reflects shortcomings in work incentives, as well as weak demand for their labour. They face high implicit taxation when moving from inactivity to employment, and from part to full-time employment, even if this was to some extent alleviated by the 2009 tax reform. The implicit taxation rate is high for inactive low-skilled women with two or more children. In addition, while the enforcement of labour market availability rules

for the recipients of unemployment insurance is among the strictest in the OECD, this is not the case for social assistance. The partition between federal responsibilities for unemployment insurance and *Länder* responsibilities for social assistance appears to be a source of inefficiency. *Labour market participation incentives of the less-skilled should be improved by reducing the implicit taxation of low-income individuals transiting from inactivity to employment, by better integrating the management of unemployment insurance and social assistance, and by providing a larger proportion of social assistance through in-work benefits.*

Business sector demand for low-skilled labour can be bolstered

The employment costs of the low-skilled are high and relatively rigid in Austria, contrasting with the degree of wage flexibility in the core labour market. Minimum wages are the main constituent of cost floors. There is no officially-legislated minimum wage, but hundreds of minimum wages negotiated sectorally, with ratios to the national average wage clearly above OECD averages. In these conditions, the recent government initiative to set a national minimum wage floor for all wage negotiations, at a level below the minimum wages in the largest sectors is likely to have only a limited impact. Still, it may affect the cost of hiring into regular jobs workers with atypical labour contracts, as well as the potential employment costs of the presently inactive or unemployed. The total costs of employing the low-skilled are also magnified by hefty employer social security contributions – among the highest in OECD. In light of the experience of other OECD countries, *the employment of the low-skilled could be boosted by substantially reducing employer social security contribution rates, although this should be fully funded by spending restraint in lower-priority areas, or increases in less distortive taxes.*

Upgrading human capital through stronger education is crucial

Austria's growth performance hinges *inter alia* on the quality of its education system. While it has long successfully equipped the labour force with very good vocational skills, it now faces the major challenge of providing youth with the new, higher and more generic skills called for by technological change, international competition and aspirations for a more equitable distribution of human capital. As in many other countries, the education system faces difficulties in responding to these challenges. It has been organised to date as a massive public service, where fiscal costs are high, the existing human and physical resources are difficult to reallocate, and management is more input than output-oriented. It also suffers from a particularly complex federal structure, with central, *Länder* and local governments fulfilling politically independent roles but having overlapping responsibilities. Reform efforts in different education layers met with problems in the past, due to limited agreement across society, political parties, teaching professionals and federal and *Länder* authorities on the key challenges and the most urgently needed changes. The new government has an ambitious education reform agenda. Achieving a degree of consensus amongst the various stakeholders will be important for its success.

Pre-school education needs to be considerably strengthened

Austria's pre-school infrastructure has some weaknesses in international comparison. In pre-school facilities, class sizes are large and socioeconomically disadvantaged, including immigrant, children are under-represented. The government has recently agreed with the *Länder*, which are constitutionally in charge of pre-schools, to have one year of free compulsory kindergarten education for all five-year old pupils, on a half-day basis. This will start to apply from September 2009, and be generalised in September 2010. Moreover, significant additional resources will be devoted to the provision of new child care facilities, the improvement of German language skills in pre-schools and the training of private childminders. Furthermore, there is an agreement to set up an education plan (*Bildungsplan*) in order to guarantee a high standard quality all over Austria. Although those are major steps forward, room for further progress is considerable. The basic policy objective should be for *all children from age three onwards to benefit from high-quality pre-school education*.

The ongoing reforms of compulsory education require deeper resource re-allocations

A major reform was launched in compulsory education in 2007, to overcome the excessively early streaming of students into "academic" and "general" tracks by promoting a new breed of "comprehensive schools" (*Neue Mittelschule*). For this to succeed, adequate teaching resources and school infrastructure are needed. At the same time, there is ample scope for the rationalisation of school and class infrastructure, and of the distribution of teaching personnel across the country. *Resources should be freed from where they are less needed, and re-allocated to the most important and innovative policy initiatives*. This agenda, however, faces a wealth of administrative and political hurdles. *The federal governments should continue with efforts to renew the structures of compulsory education by providing more autonomy to schools, in exchange for improved accountability in meeting national education standards*.

The intended development of high-quality tertiary education is not on track

University enrolment is relatively low in Austria, especially in science and engineering. The government intends to offer high-quality tertiary education to a larger proportion of the young. However, universities' existing organisational and funding arrangements are not well-suited to this ambition. In principle, universities are required to register all qualified applicants to the programmes and courses of their choice, without any selection and at no financial cost to the student. The resulting imbalance between ambitious service objectives and limits on available resources has started to undermine the quality of education. Alternative tertiary institutions, which select students and charge fees, have begun to provide arguably better and more labour-market-relevant education. Whilst waiting for more comprehensive reforms, *growing registration demand needs to be met without compromising teaching quality. Universities should have greater leeway to select their students and charge tuition fees, with a comprehensive student grant and income-contingent loan system ensuring equality of opportunity*.