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ECONOMIC ANALYSIS FROM EUROPEAN COMMISSION'S DIRECTORATE-GENERAL FOR ECONOMIC AND FINANCIAL AFFAIRS

HIGHLIGHTS IN THIS ISSUE:

- *Different patterns of tax-transfers balance in States and municipalities have an influence on their fiscal performance;*
- *Subnational expenditure dynamics are mainly driven by specific factors such as developments in the health sector;*
- *Linking subnational budgetary targets to national macroeconomic variables may reduce the effectiveness of the rules at subnational level;*
- *Subnational fiscal rules effectiveness depends on their ability to foster specific organisational and sectorial reforms.*

Austria's fiscal rules: climbing the mountain towards effective fiscal relations

*By Raffaele Fargnoli**

Summary

This study of Austria's fiscal framework discusses positive aspects and weaknesses of recent reforms in intergovernmental fiscal relations by analysing from a backward and forward looking perspective some of the factors driving subnational fiscal performance. Looking back, transfer dependency has differed between various levels of government and coincided with different fiscal outcomes for State governments (Länder) and local governments. The fiscal framework has not been able to prevent State governments from consistently missing their budgetary targets from 2001 to 2009, causing a significant drag on Austria's overall budgetary position. In response, reforms going in the direction of higher tax sharing and lower transfer dependence for subnational governments have provided stronger incentives to curb expenditure, paving the way for better fiscal performance in recent years. Looking forward, the analysis focuses on the new system of fiscal rules adopted in Austria, aimed at reinforcing the budgetary framework through the introduction of multiple fiscal rules that are extended to subnational governments. The reform has reinforced the link between structural macroeconomic variables and subnational budgetary targets, in particular by capping subnational expenditure dynamics to national potential output growth. Although the new rules constitute progress, their design may in some respects be ineffective to ensure the respect of the targets. In particular the link between potential output and subnational expenditure growth may prove difficult to maintain in light of the volatile nature of subnational spending in Austria, which is often caused by specific recurrent expenditure overruns. In this respect, the study presents the underlying factors driving the dynamic of subnational health sector expenditure, such as recurrent subsidies and capital transfers to the health sector, and confirms that the effectiveness of Austria's new fiscal framework will depend on the interplay of comprehensive organisational and structural reforms in order to tackle inefficiencies and reduce the underlying trend expenditure growth.

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Introduction

The EU budgetary surveillance increasingly focus on budgetary frameworks in Member States since past developments show that they are crucial to ensure that obligations at EU level can effectively be met. Also, preliminary evidence points to a certain correlation between the average fiscal outcomes in the EU and some features of the budgetary framework, notably the extent of fiscal decentralisation, the rate of coverage of subnational expenditures by own resources and the weight of taxes in subnational revenues (see Public Finances in EMU 2012, chapter 3).

Overall, Austria's fiscal framework has been conducive to enhancing budgetary discipline and avoiding pro-cyclical policies. However, it has not enabled Austria to achieve a balanced budget over the business cycle. The country specific recommendations addressed to Austria in the framework of the European Semester emphasise the need for strengthening the fiscal framework and streamlining fiscal relations between levels of government. Fiscal framework indicators by the European Commission (see European Economy, Occasional paper n.92, 2012) point out that Austria is not among the best performers on the fiscal rules index[1]. In particular, fiscal relations between different levels of government remain complex and marked by overlapping competencies in key expenditure categories, such as healthcare, education and social transfers.

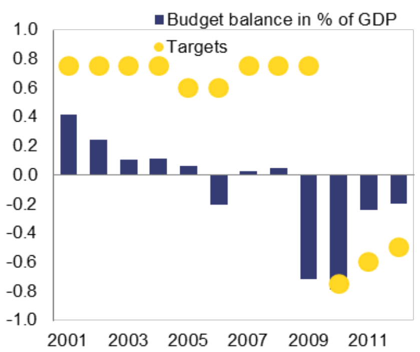
In December 2011 Austria adopted a broad reform of its fiscal framework through a new and strengthened Austrian Internal Stability Pact (AISP). This followed the 2008 reforms of the equalisation law, which went in the direction of increasing the source of subnational revenues coming from shared taxes while reducing intergovernmental transfers. The 2011 reform introduces a system of multiple fiscal rules applying to each level of government, including nominal and structural deficit targets, expenditure rules and enhanced sanction mechanisms. This country focus looks at past outcomes in States' and local governments' fiscal performance and examines some of the factors underlying subnational budgetary developments. Against this background, it aims to discuss positive aspects and weaknesses of these reforms by analysing subnational fiscal performance from a backward and forward looking perspective.

Subnational deficit targets and outcomes

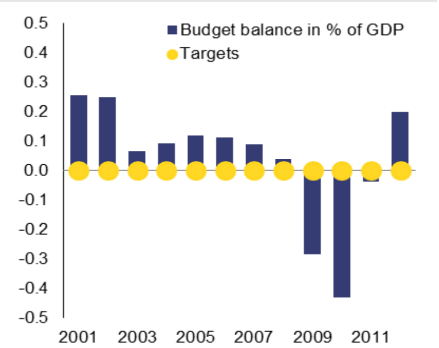
State governments' budgetary targets have been often missed.

In the last decade, the centrally established deficit targets for subnational governments have been often missed. State governments (Länder) consistently failed to meet their budgetary targets from 2001 to 2009[2]. As a result the long-term average of States' budget balance decreased from a surplus of 0.6% of GDP in the period 1988-2000 to a deficit of roughly 0.1% of GDP in the period 2001-2011. On the contrary, local governments have shown better compliance since they over-achieved their targets in most years (charts 1 and 2).

Graph 1: State balance as % of GDP



Graph 2: Local governments balance as % of GDP



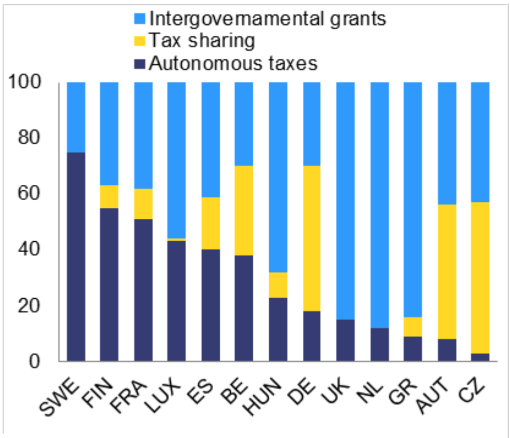
Source: Commission Services based on OECD, Eurostat data

■ *Subnational revenues are composed of high tax sharing, medium transfers and low autonomous taxes*

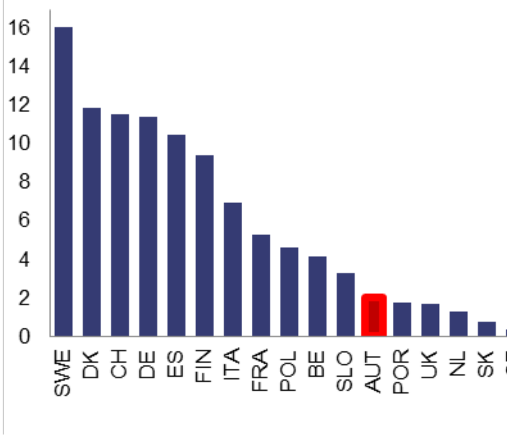
From 2009 the large economic downturn, the functioning of automatic stabilisers and counter-cyclical discretionary measures have led to higher deficit in both States and local governments. Consolidation started in 2011 when the different layers of government took measures to reduce their budget deficit. States over-achieved their targets in 2011 and 2012, while local governments over-achieved their target in 2012.

Subnational governments' expenditure can be financed by own subnational revenues, tax sharing and intergovernmental transfers. Although the distinction is not straightforward, the composition between these three sources of revenue differs considerably among countries. The OECD includes Austria among the countries characterised by low autonomous taxes, high tax sharing and medium transfers (chart 3).The share of own taxes is particularly low with respect to other countries (chart 4). In addition, subnational governments have little discretion in setting the tax rate and the tax base.

Graph 3: Sources of subnational revenues in selected EU countries in 2011



Graph 4: Subnational own taxes as % of GDP in 2011

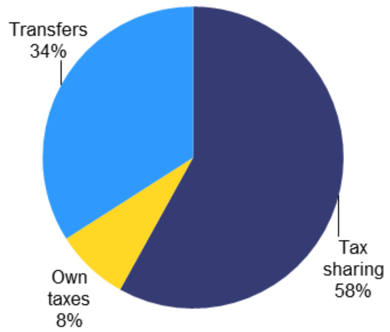


Source: OECD

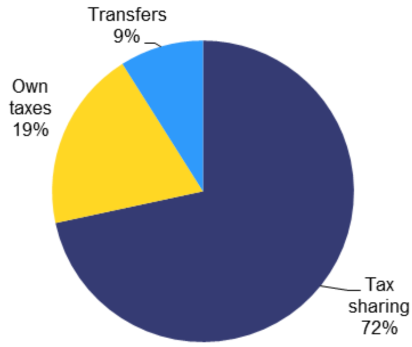
■ *States rely more on transfers and have a lower share of own taxes than municipalities...*

Different studies (European Commission, IMF) classify Austria as a country with relatively low vertical imbalances[3] considering together state and local governments' revenue and expenditure. However, by looking at the revenue composition of States and municipalities separately, two different patterns emerge. Tax sharing and own taxes constitute a much larger portion of local governments' revenue than that of States, while transfers play a bigger role in the States' revenue (charts 5 and 6). Furthermore the share of municipalities' own taxes in total local revenues is more than double that of States, implying larger vertical fiscal imbalance in the States then in municipalities (charts 7 and 8).

Graph 5: States revenues 2011



Graph 6: Municipalities revenues 2011

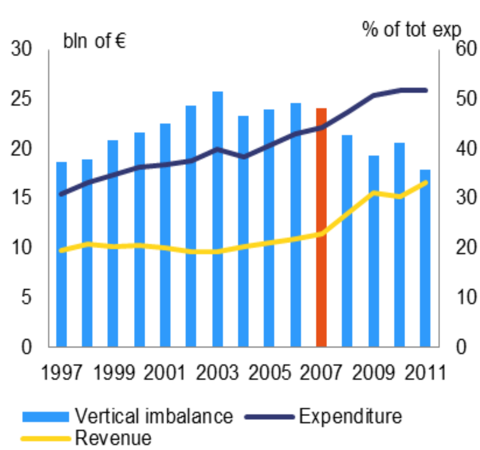


Source: OECD

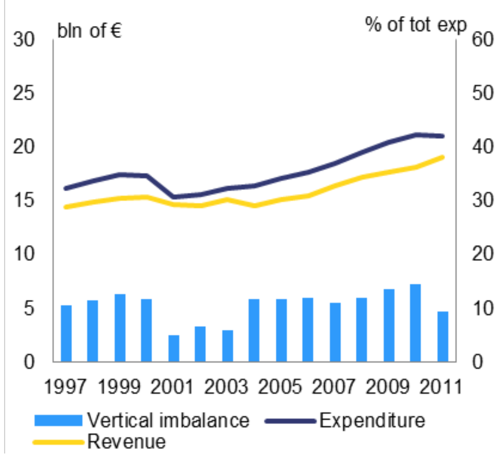
■ *... leading to higher vertical imbalances and possibly lower fiscal performance*

The fiscal performance of Austrian subnational levels of government, assessed in terms of compliance with the targets established in the previous AISP, seems to confirm the general findings of the theory of fiscal federalism. The literature generally emphasizes the risks associated with large vertical imbalances. A common finding is that a high reliance on transfers softens the budget constraint of sub-national governments, leads them to overspend, and lowers their tax effort, mainly because they do not fully internalise the cost of spending and/or because they are aware that their financing gap will be covered by additional transfers. Conversely, allowing sub-national governments to dispose of more own revenue mainly through local taxation is seen as promoting fiscal discipline (Oates, 2006; IMF, 2009; Blöchliger and Petzold, 2009). Other studies show that transfer dependency is often linked with larger fiscal deficits, especially if associated with a large extent of expenditure decentralisation and soft borrowing constraint (Rodden and Wibbels, 2009).

Graph 7: Vertical fiscal imbalance states



Graph 8: Vertical fiscal imbalance local governments



Source: OECD

Fiscal outcomes at State level started to deteriorate after 1997, when States' vertical imbalances gradually widened and transfer dependency increased. Up to 2007 sluggish revenue growth and higher expenditure dynamics explain the increase of States' vertical imbalances. In the following years the higher correlation between revenue and expenditure is also due to the 2008 reform of the fiscal equalisation law which brought a change in the direction of higher tax sharing and reduced transfers. This could have facilitated the ability of State governments to meet their targets in an environment of strong consolidation needs. On the other hand, local governments have shown, over time, good compliance with their targets, with revenue and expenditure more correlated in most years. The higher tax sharing and a wider portion of autonomous taxes, resulting in lower vertical imbalances, may be one factor behind this better track record.

The reform of the Austrian Internal Stability Pact

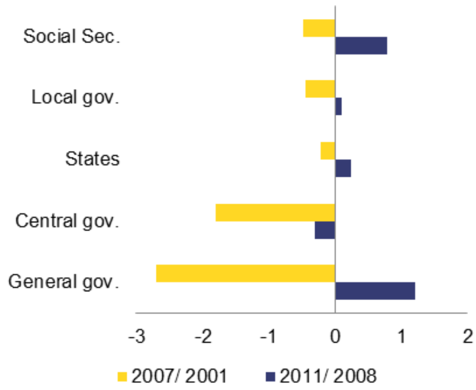
At the end of 2011 the government approved a new AISP, which broadly mirrors the design and targets of new rules adopted at European level. The aim is to reinforce the budgetary framework, mainly through the introduction of a new system of multiple fiscal rules that are extended to subnational governments. The main rules involve: a) more stringent deficit targets for the different levels of government; b) a new structural balance rule, which will be applied from 2017 onwards, that sets a lower limit of general government structural deficit at -0.45 % of GDP (-0.35 % for the central government and -0.1 % for states and local governments); c) in line with the preventive arm of the European Stability and Growth Pact, expenditure growth in all government levels (net of discretionary measures) must not exceed average potential growth and must follow the adjustment path towards the MTO; d) a new debt rule designed as the European one covering all levels of government. The new AISP as well as the presence of stronger enforcement mechanisms are important novelties compared to previous arrangements.[4]

However, in light of past outcomes, where subnational deficit targets were frequently missed or renegotiated, the actual effectiveness of the new rules will require diligent and strict implementation.

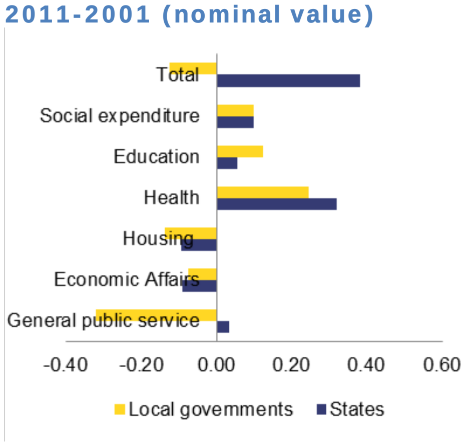
Some factors could reduce the effectiveness of the new fiscal rules at subnational level

In addition, the design of the rules at subnational level could in some respects potentially jeopardise their application. National potential output is used as the key reference value both for the structural budgetary targets and for the expenditure rule. Although revenue sharing and cyclical unemployment expenditure at central level to some extent insulate subnational budget balances from the business cycle, the volatility of subnational expenditure combined with the absence of revenue-raising power could, by design, endanger the respect of the targets. In addition, building the credibility of subnational rules linked to macroeconomic variables will require reducing the number of incidents where expenditure overruns at subnational level are driven by specific expenditure developments in particular sectors, most notably in the health sector. Hence, a crucial prerequisite for success of the new framework is that the set of rules will be able to foster a comprehensive overhaul of those sectors, where expenditure slippages systematically materialise.
Exploring the dynamics of subnational expenditure, in particular by looking at the underlying variation of the expenditure/GDP ratio by sectors, allows identifying some of the main drivers behind the expenditure developments over the last decade

Graph 9: Change in expenditure / GDP ratio by Gov. levels (%)



Graph 10: Change in the expenditure / GDP ratio by sector 2011-2001 (nominal value)



Source: Commission Services based on Eurostat data

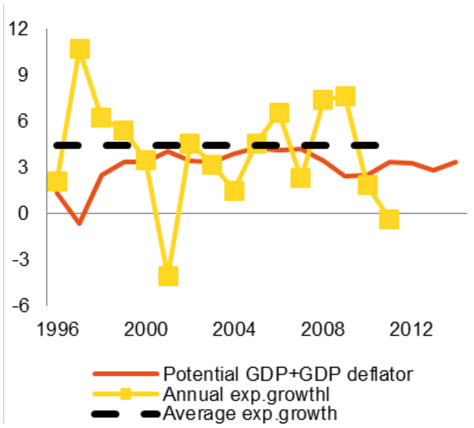
Health expenditure accounts for a large part of expenditure growth both in States and municipalities

State governments experienced the lowest reduction in the expenditure ratio in the period 2001-2007, while from 2008 the rise was among the highest and more than offset the previous decrease (charts 9 and 10). Central and local governments experienced the largest expenditure reduction until 2007, which was for the most part safeguarded in 2008-11. The marked increase of the social security expenditure ratio since 2008 is mainly due to its strong cyclical features. The pattern of sectorial expenditure shows that most of the increase in the expenditure ratio in both state and local governments occurs in the health sector. Health expenditure increase accounts for the bulk of the overall rise of the State governments' expenditure ratio, while for local governments the increase in health spending has been offset by expenditure reductions in other areas.

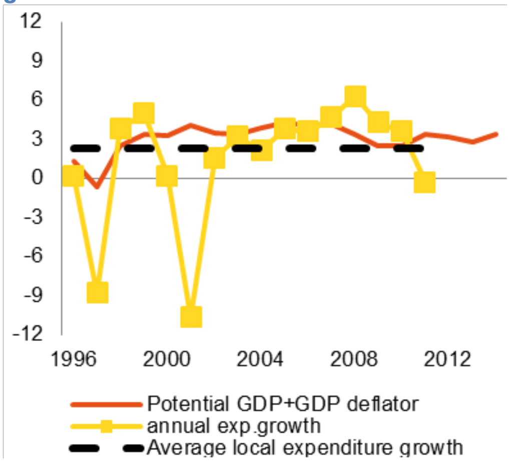
Subnational expenditure often departed from average potential growth.

States' and local governments' expenditure appears quite volatile especially when compared to other EU Member States, even if Austria's subnational expenditure is found to respond less to cyclical factors than in a number of EU Member States (see OECD 2010, OENB 2013). The annual nominal expenditure growth of both States and municipalities overshot in many years an approximation of the new expenditure rule (including only its main component, namely multi-year average potential GDP growth computed broadly in line with the benchmark of the new EU economic governance). Moreover, States' average expenditure growth has in the past been above this benchmark (charts 11 and 12). Subsidies and capital transfers are the main drivers of expenditure overruns. Local governments perform slightly better, since the average expenditure growth remains below the reference ratio. However, in some years expenditure growth departs considerably from the reference ratio such as in 2008 when subsidies to the health sector drove up local expenditure growth.

Graph 11: States expenditure and potential GDP growth



Graph 12: Local governments expenditure and potential GDP growth



Source: Commission Services based on OECD data

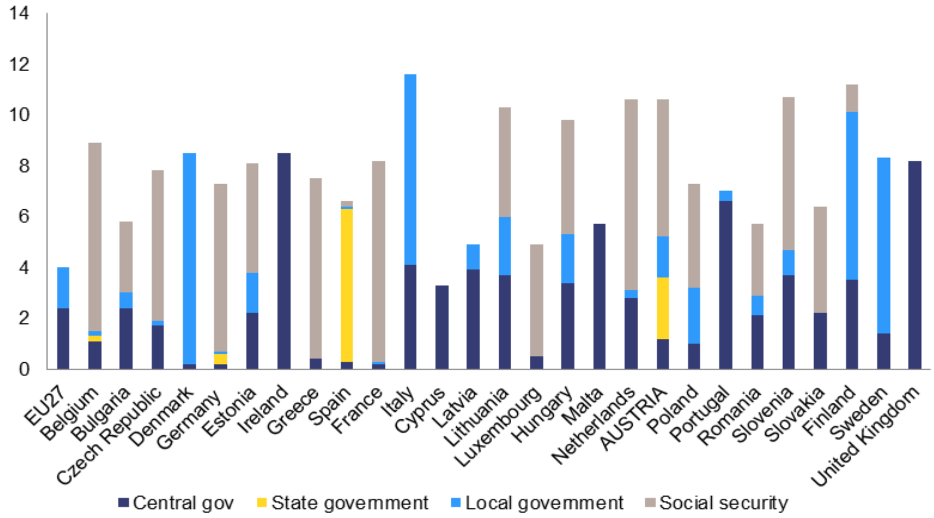
Overall, the expenditure profile of subnational governments shows clear-cut patterns: i) subnational expenditure is quite volatile; ii) States' expenditure to GDP ratio grew more than that of municipalities; iii) a sustained rate of expenditure growth occurred in the health sector for both levels of government; iv) expenditure overruns are often due to specific recurrent circumstances related to the financing of the health sector.
Against this background subnational budget balance targets could be undermined by expenditure dynamics, with expenditure overruns often caused by structural factors. The effectiveness of the fiscal rules will therefore depend on their ability to foster reforms in specific areas such as the health sector.

A case in question: Organisation of the health system

- *Health expenditure is very fragmented among different government levels*

Sustained health expenditure growth is a common characteristic in EU countries due to ageing dynamics. Austria's health expenditure evolved in line with the European average between 2001 and 2011. That said, Austria's total general government outlays for the health sector have traditionally been among the highest in Europe. Data for 2011 shows that Austria is among the countries that devote the highest amount of public resources to the health system, while projections up to 2060 place Austria in the third position in this respect (see European Commission, Ageing Report 2012).
The health system is generally regarded to perform well on standard output indicators. However the organisation structure appears very complex due to high fragmentation of organisational responsibilities and spending and funding powers among the different layers of government. Austria is the only EU country where all levels of government, including social security funds, account for a considerable share of total public health expenditure (chart 13). Consequently any level of government plays a strategic role in steering the system. The federal level, States and local governments are simultaneously involved in providing hospital services, while outpatient care is provided by social security services. The outcome of this complex architecture is that inpatient care is strongly predominant over outpatient care. States provide most of the inpatient services through their own hospitals while funding is provided by transfers from central government and social insurance funds. Thus the States do not have any clear incentive to consolidate hospitals capacity and shift it towards outpatient care.

Graph 13: Health expenditure by government level as % of GDP, 2011

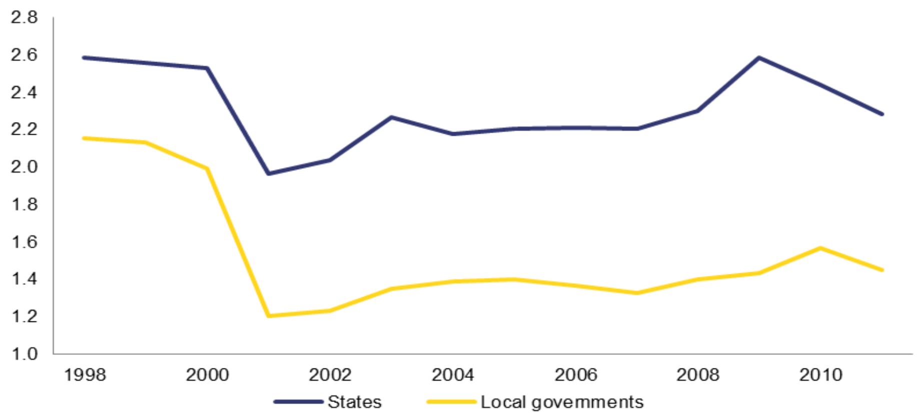


Source: Eurostat

Spending for hospitals suffers from efficiency concerns

From the second half of the 1990s to the early 2000s, many State and municipal hospitals were transformed into private corporations owned by subnational governments, but recorded outside public accounts. This has led to a large reduction of health expenditure in States and local governments, accounting for roughly 0.5% and 0.8% of GDP respectively. In the following years the steady rise of ordinary subsidies to hospitals for their day-to-day functioning, together with occasional capital transfers to cover hospitals' debt, brought States' health expenditure up to their pre-privatisation level (in % of GDP). In local governments, although expenditure remained well below that of the pre-privatisation period, a similar pattern can be observed (chart 14). In addition, studies on hospital funding efficiency (Hofmarcher et al, 2005, Czypionka et al, 2008) estimate that large potential efficiency gains could be reaped. Hospitals owned by local governments seem to be more efficient than hospitals owned by the States, although variation is high within both groups.

Graph 14: evolution in the health expenditure as GDP ratio

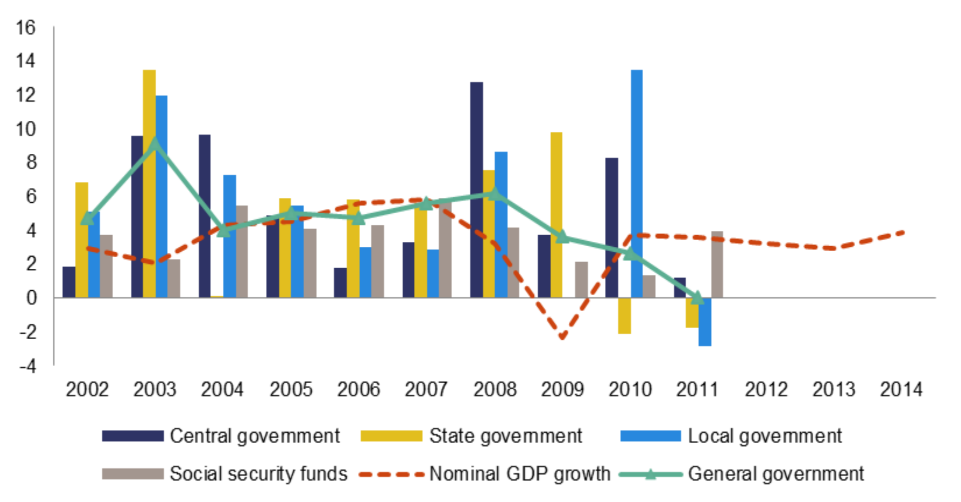


Source: Eurostat

Past developments show that bringing health expenditure in line with GDP growth is difficult without substantial reforms

In the context of the reform of the AISP, an agreement has been reached among the different level of governments to limit health expenditure growth to average nominal GDP growth until 2016. From 2016 onwards, public health expenditure growth will be limited to 3.6%, in line with expected average nominal GDP growth. In the past, general government health spending followed GDP growth in years when output growth was quite robust. However, when the economy slowed down or specific events drove up health expenditure, past experience shows that such a rule may be difficult to sustain. It is, however, promising that States' health expenditure after having exhibited for many years a rate of growth above those of other levels of government and above nominal GDP growth, was much better controlled in 2010 and 2011 (chart 15). Yet, with an average annual growth of 4.5% in the period 2002-2011, respecting a 3.6% annual growth as targeted by Austrian authorities for the future may be challenging against the background of the full effect of ageing.

Graph 15: Health expenditure growth by subnational Gov. and GDP growth



Source: Eurostat

Conclusions

Over recent years, reforms have strengthened Austria's fiscal framework. While the 2008 reform of the fiscal equalisation law focused mainly on the relations among different layers of government, the recent reform of the AISP introduces a system of fiscal rules, mirroring those applied at European level, covering both the general government and the different government levels. Although in many respects a step forward, the analysis has shown that, beside political economy considerations, linking subnational budgetary targets to national macroeconomic variables may not in itself be enough to limit recurrent expenditure overruns at subnational level, driven by specific expenditure developments in particular sectors, most notably in the health sector.

In the Austrian case, the ability of States and local governments to respond to expenditure shocks is not high. The limited room for manoeuvre, in particular for State governments, is the result of relying for a large part on intergovernmental transfers and shared taxes, while having low tax autonomy and facing a dynamic of expenditure that is difficult to contain in the short-run. The effectiveness of the new fiscal framework will therefore depend on the ability to foster comprehensive organisational and structural reforms that can tackle inefficiencies and reduce the underlying trend expenditure growth.

The Austrian experience seems to confirm the importance of combining well-designed fiscal rules with proper institutional arrangements able to provide an efficient incentive structure for subnational governments. Past reforms going in the direction of higher tax sharing and lower transfer dependence for subnational governments have provided stronger incentives to curb expenditure, paving the way for better fiscal performance in recent years. Looking forward, dealing with the fragmentation of organisational responsibilities and the mismatch between spending and funding powers among the different layers of government would naturally complement recent reforms of federal fiscal relations and the reinforcement of Austria's fiscal framework.

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1 The last update of these indicators does not take into account the recent reforms of the AISP.
2 On the basis of vintage data differences between targets and outcome were somehow lower. However this was due to accounting principles which encouraged local entities to granting loans instead of injecting capital into the hospital sector. These operations are not recorded under general government expenditure and do not cause increase in the deficit.
3 The concept of vertical imbalances used here refers to the share of subnational expenditure (minus intergovernmental transfers paid) not covered by subnational revenues (both shared and autonomous, excluding transfers received from other level of government). By definition, the counterparts of vertical imbalances are sub-national borrowing and transfers received from other units of general government.
4 The existing legally binding Medium-Term Expenditure Framework introduced in 2009 applied only to five main central expenditure categories, covering about 75% of the central government outlays. The expenditure ceilings do not cover subnational level expenditure and therefore included just 40% of the total general government expenditure.