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Country Report Austria 2016

Including an In-Depth Review on the prevention and correction of macroeconomic imbalances

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EXECUTIVE SUMMARY

This country report assesses Austria's economy in light of the European Commission's Annual Growth Survey published on 26 November 2015. The survey recommends three priorities for the EU's economic and social policy in 2016: re-launching investment, pursuing structural reforms to modernise Member States' economies, and responsible fiscal policies. At the same time, the Commission published the Alert Mechanism Report that initiated the fifth round of the macroeconomic imbalance procedure. The Alert Mechanism Report identified Austria as warranting an in-depth review.

After four years of slow economic growth, the Austrian economy is expected to expand. Austria's economy has been on a rather flat growth path since 2012, but the growth rate is projected to pick up from 0.7 % in 2015 to around 1½ % in 2016 and 2017. This acceleration is expected to be driven by private consumption and housing investment. Investment activity has been sluggish, but is expected to pick up due to improved confidence, favourable financing conditions and the need to renew equipment. The unemployment rate is expected to stay contained at around 6 %. Inflation should return to almost 2 % in 2017 as the dampening effect of energy prices fades. The tax reform and additional expenditure on refugees and migrants add pressure to the fiscal outlook. The headline deficit of 1.6 % in 2015 is nonetheless projected to stabilise at 1.7 % in 2016 and 2017. Public debt increased in 2014-2015 due to the impact of financial sector measures, but is projected to fall to 84 % of GDP in 2017.

Sluggish investment activity has been an important reason for slow economic growth in Austria in recent years. Subdued investment followed in the wake of overall weak export market prospects, including relatively pronounced market share losses of Austrian exporters. It coincided also with declining corporate profits and a continuous reduction of non-financial corporate debt along with muted corporate credit growth. At the same time, major banking groups have been addressing their challenges from low profitability, increasing non-performing loans in their foreign subsidiaries, and important foreign currency loan exposures. This went hand-in-hand with supervisory and regulatory action, both in Austria and at the European level, which set a necessary focus on building capital buffers and de-risking of bank balance sheets. Moreover, government bank support measures taken in the past to preserve financial stability and restructure distressed banks have continued to impact on public finances. Although the banking sector has remained resilient, some issues in relation to specific banks have impacted on investor sentiment, what has been reflected in bank capital costs. The 2015 Council recommendation to Austria already recognised these challenges and pointed to the need to address potential financial sector vulnerabilities.

Austria faces a number of other challenges in order to improve its growth and investment dynamics and preserve sound public finances in a way that supports growth by increasing the efficiency of public expenditure while reducing public debt. This entails to take steps to increase efficiency in the public sector and secure long-term sustainability of public finances. Particularly pensions, healthcare and long-term care constitute challenges for the future. Strengthening economic growth and investment to bring them back to pre-crisis levels constitutes an ongoing challenge for Austria for which many opportunities exist. Improving competition in the services sector and access to it would create new investment opportunities and strengthen business dynamics. Strengthening the activity rate of older workers and women would contribute to ensuring the long-term availability of adequately qualified labour.

Overall, Austria has made limited progress in addressing the 2015 country-specific recommendations. Measures to finance the 2016 tax reform may not yield the expected revenues, and this poses a risk to compliance with fiscal rules. No concrete proposals have been put forward for streamlining federal fiscal relations. Efforts to ensure the long-term sustainability of the pension system have been limited to reducing access to early retirement, with no action towards linking the retirement age to life expectancy or bringing forward the alignment of women's retirement age with that of men. There has been only limited progress towards the better use of the labour market potential of older workers, women and workers with migrant background. The same is the case as regards improving the educational situation of disadvantaged young people. In the services sector, no measures have been taken to increase competition.

Regarding progress in reaching the national targets under the Europe 2020 Strategy, Austria has already reached its targets on tertiary education attainment and on limiting early school leaving. Austria is on track as regards the renewable energy target while more effort is needed in terms of research and development expenditure, reduction of greenhouse gas emissions, improving energy efficiency and reducing poverty and social exclusion.

The main findings of the in-depth review contained in this country report, and the related policy challenges, are as follows:

- **Austria's banking sector is resilient, but faces some key challenges, in particular below average capitalisation, low profitability and reduced loan portfolio quality for the subsidiaries abroad.** Supervisory actions have helped to further improve bank capitalisation and the effects of the banks' balance sheet adjustments on other sectors have been contained. These achievements are important, but ongoing efforts are needed to ensure that the sector's lending capacity is preserved and that potential vulnerabilities are addressed, as recommended by the Council. Structurally low profitability in the domestic market, increased provisioning needs and more volatile earnings from abroad owing to economic and political risks in several markets remain important challenges to be addressed. Going forward, further improvements in profit generation and efficiency, de-risking abroad and building capital buffers, as planned, would bolster resilience and mitigate the tail risk of the supply of bank credit not keeping up with improved economic prospects.

- **Austrian banks' focus on Central, Eastern and South-eastern Europe contributes to profit generation, but entails also a risk of spillovers**. The large foreign exposure of the Austrian banking sector has declined in recent years, but the share of foreign currency lending is still sizeable in several cases. Despite the strategic merits of Austrian banks' engaging in dynamic economies, this does involve relatively pronounced credit, currency and political risks, as highlighted by developments in Russia and Ukraine. Supervisory guidance to increase risk-bearing capacity, improve funding sources abroad and closely monitor risks has been stepped up, thus mitigating the risk of bank-specific problems impacting on the Austrian economy.

- **The restructuring of Austria's banking sector has reached a point where it advances without the need for additional public support.** Crisis-related public support for the Austrian banking sector has been significant. On the one hand, these measures involved sizeable net costs for public finances. On the other hand, public intervention averted the potential negative consequences on financial stability. Looking ahead, a limited further impact on public finances of past financial sector support measures could still occur, but this would mainly relate to legacy issues in specific institutions.

- **Austrian exporters' loss of market share in recent years does not appear to pose a serious risk to future growth.** Geographical specialisation, especially in EU economies, has meant that Austria has taken comparatively less advantage of the growth in overseas markets such as China, Brazil, India and the US. At the same time, the loss of market share in terms of volume is much more limited than in terms of value. Also, as Austria's traditional export markets are faring better some market shares have been regained. Austria has experienced some loss in price and non-price related competitiveness in recent years, which requires monitoring but in a longer time perspective appears to be limited.

Other key economic issues analysed in this report which point to particular challenges for Austria's economy are:

- **Organisational relations between levels of governments remain complex and inefficient.** The 2012 reform of Austria's Internal Stability Pact helped contain sub-national expenditure. However, efficiency gains could be reaped by better aligning revenue-raising and spending competencies and by reducing the fragmentation of organisational tasks. The complexity of fiscal relations and government accounts pose challenges, including to the effectiveness of monitoring.

- **The 2016 tax relief on labour income is significant, but further potential exists.**

Greater attention could be paid to reducing the tax burden on lower income earners, which would further strengthen work-incentives and consumption for these groups. This could be financed by shifting the tax burden to more growth-friendly sources of taxation, increasing recurrent property taxation on housing and applying higher environmental taxes, which would also help to achieve environmental targets.

- **Austria has one of the lowest activity rates for older people in the EU.** Measures were taken to restrict access to early retirement and invalidity allowances for people under 50. The government also committed itself to employment targets for older workers and intensified its active labour market policy for this group. Further measures would benefit the sustainability of the pension system. A debt sustainability analysis conducted by the Commission assessed Austria as facing medium fiscal sustainability risks, due to the still relatively high stock of debt at the end of the projection (2026).

- **Women are still disadvantaged in the labour market.** The gender pay gap is well above the EU average and this has not changed substantially in the last decade. Many Austrian women working part-time report the need to provide care to children or ailing relatives as the main reason. The current schedule of aligning women's statutory retirement age with that of men implies that in 2020, despite high life expectancy, Austria will have the lowest statutory retirement age for women in the EU.

- **The unprecedented inflow and transit of refugees and migrants will demand efforts from authorities and society to enable integration and social inclusion.** Language training is a necessity for integration and to help children participate in the education system. The current inflow adds to an earlier challenge of integrating people with a migrant background. Disadvantaged young people, often with a migrant background, still tend to have poorer school results and a lower level of education.

- **Rigidities in the service markets and liberal professions are hampering competition and ultimately investment.** Improving the business environment in the services sector is an area for further action, and would also benefit other parts of the economy. A high administrative burden and restrictively regulated market access weigh on the starting of new businesses. Austria identified the potential for improvement in the services sector, but is yet to take action.

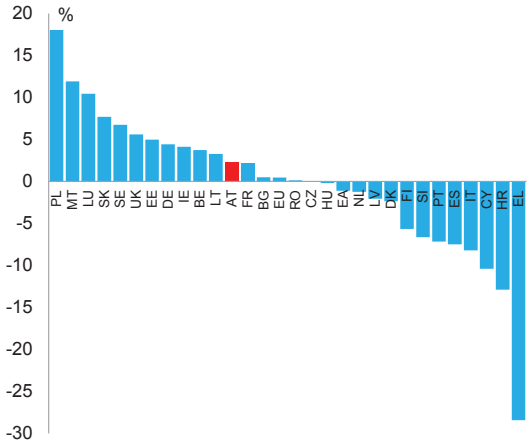
- **Regulatory barriers, the administrative burden and limited options to finance are still major obstacles to investment dynamics.** Low interest rates and low oil prices are providing a temporarily supportive investment climate. However, structural barriers are still restraining investment. Regulatory barriers, such as restrictive licensing and permitting systems or barriers to market access for service providers, discourage new investments. More diversified financing options especially for SMEs and start-ups would also provide better investment opportunities.

1. SCENE SETTER: ECONOMIC SITUATION AND OUTLOOK

Economic growth

Austria has weathered the global economic and financial crisis well. Before the financial crisis Austria's economy showed robust development, with no pronounced boom-and-bust phases. The impact of the crisis was strongest in 2009, but a similar strong recovery followed before growth largely levelled off after 2012. GDP increased cumulatively 2.4 % from 2008 to 2014 (Graph 1.1). This relatively stable economic development is also reflected in the overall good labour market conditions. The crisis did not lead to a significant increase in the unemployment rate which oscillates at a comparatively low level of around 5 % to 6 % (Graph 1.2).

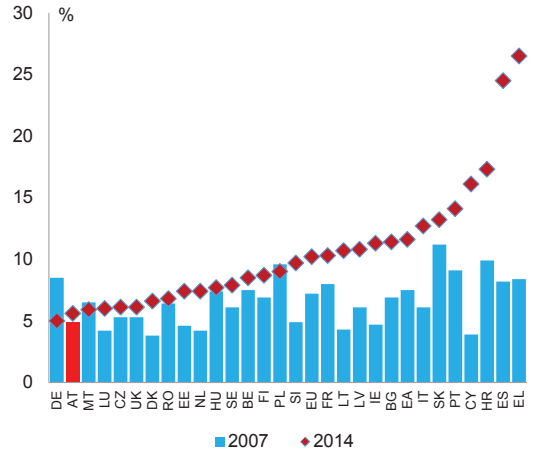
Graph 1.1: **Cumulative real GDP growth, 2008-2014**



Source: Eurostat, European Commission

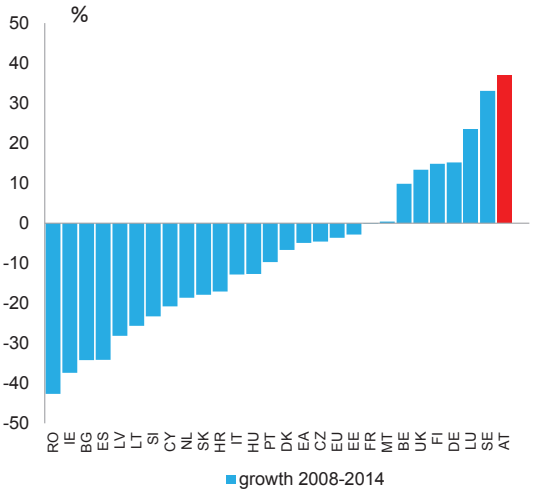
Unlike many other European countries Austria did not experience rapidly increasing debt levels. Both households and non-financial corporations kept their pre-crisis debt levels relatively stable with households slightly reducing and non-financial corporations slightly increasing their debt levels. Equally, government expenditure grew at a modest rate before the crisis, keeping public debt under control until 2007 and leaving enough room for manoeuvre on the fiscal side to weather the crisis. House prices have risen continuously, avoiding spikes before the crisis and with positive growth rates in recent years, marked by more dynamic increases in large cities (Graph 1.3).

Graph 1.2: **Unemployment rates 2007 and 2014**



Source: Eurostat

Graph 1.3: **House price index, change 2008 - 2014**

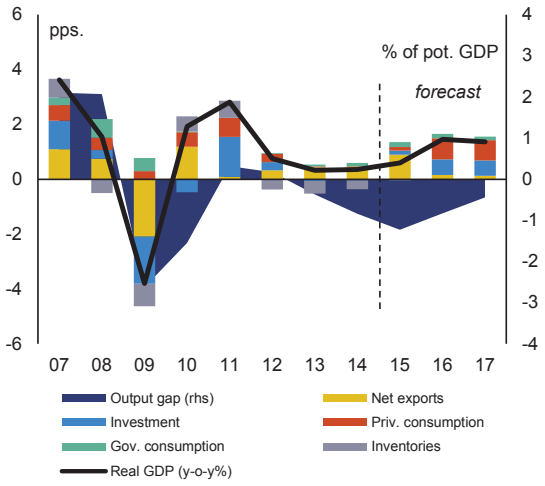


Source: Eurostat

Economic activity has stalled for the fourth consecutive year. Net export growth has slowed down significantly compared with the pre-crisis situation (Graph 1.4). Domestic demand has been characterised by weak consumption and investment growth despite a robust labour market and favourable financing conditions. In 2015, GDP growth is expected to remain subdued amid

lingering uncertainty. Activity in all sectors remains weak. Domestic demand is driven mainly by government spending, while private consumption is muted and investment activity is low. The foreign trade balance remains positive but is markedly affected by a decline in exports to China and Russia.

Graph 1.4: **Real GDP growth and contributions, output gap**



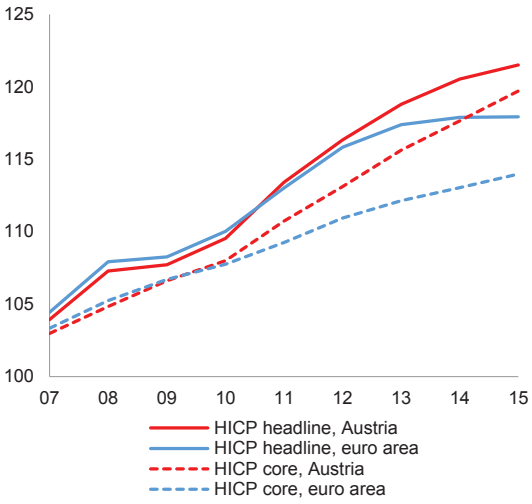
Source: Eurostat

In 2016-2017 GDP growth is expected to improve. The positive outlook is driven by an expected acceleration of private consumption following the 2016 tax reform that will increase households' disposable income by up to 4 %. Investment activity is projected to pick up noticeably, driven by the need to replace equipment. Housing investment is expected to profit from the favourable financing conditions. External trade is expected to contribute marginally to GDP growth in spite of the overall challenging climate of international trade.

Inflation

Consumer price inflation has held up compared with other euro area countries. Inflation remains stable and positive. This is due to price increases in services like renting and hospitality (tourism sector). Core consumer prices and, more recently, headline consumer prices are developing faster in Austria (Graph 1.5). Inflation, which stood at 0.8 % in 2015, is expected to increase to just under 2 % in 2016-2017 in line with the pick-up in economic activity and the fading impact of low energy prices.

Graph 1.5: **Headline and core HICP (harmonised index of consumer prices), Austria and euro area**



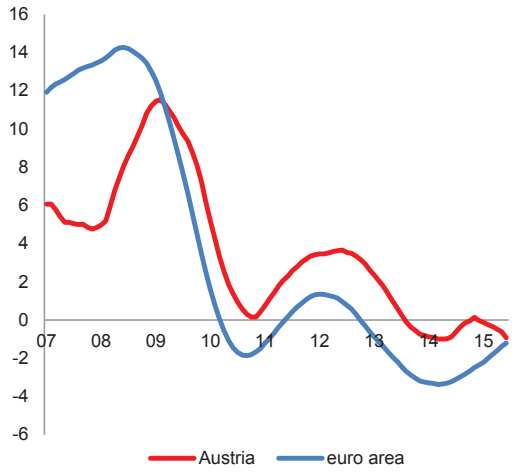
Source: Eurostat, European Commission

Credit

Credit growth has remained weak despite favourable financing conditions (see section 2.1.). Although the interest rate level is low, this is not benefiting credit growth (Graph 1.6). This is partly due to somewhat tighter credit conditions following the crisis together with weak credit demand from corporates. Interest rates are at an historic low, even though wider bank margins on loans are partially dampening the effects on financing costs.

The restructuring of Austria's banking sector is proceeding but some challenges remain (see sections 2.1., 2.2. and 2.3.). In the light of the financial crisis, the government had to provide support measures to several Austrian banks, revealing weaknesses in the financial sector. Engagements in Central, Eastern and Southeastern European countries, combined with increasing levels of non-performing loans, negatively affected the profitability of Austrian banks. At the same time, the banking sector suffers on the domestic market from low margins and high costs due to extensive nationwide branch networks.

Graph 1.6: **% annual credit growth, monetary financial institution loans to non-financial corporations**

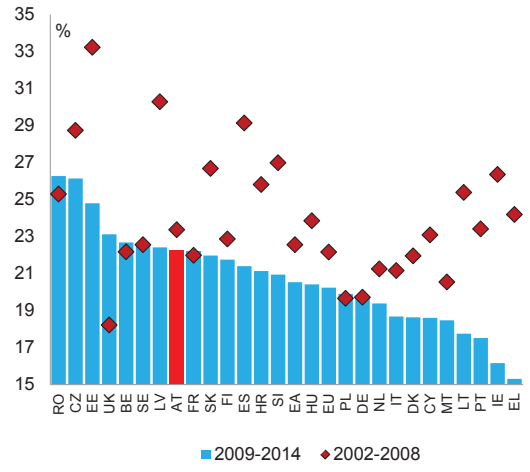


Source: European Central Bank, OeNB (central bank of Austria)

Investment

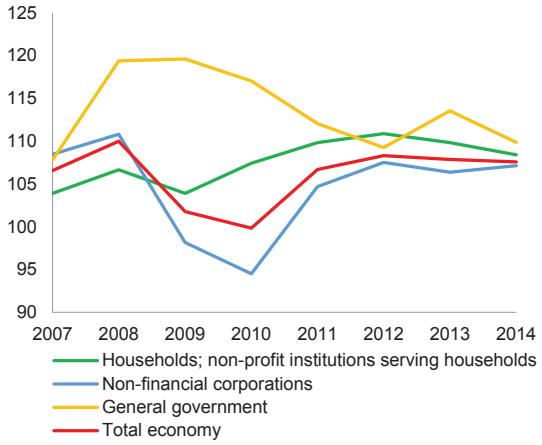
Overall investment activity remained stable during the crisis, but investment growth has since been weak (see Box 1.1). Despite weak credit development, Austria's investment rate has varied at around 22 % of GDP since the recession of 2009, just one percentage point below its pre-crisis level (Graph 1.7). However, although corporate liquidity is solid and financing conditions favourable, investment has developed only sluggishly since 2012 across all sectors. This includes public sector investment, which has remained broadly flat since the crisis (Graph 1.8).

Graph 1.7: **Investment rate, average 2009-2014 and 2002-2008**



Source: Eurostat

Graph 1.8: **Investment in sectors (index 2005 = 100)**

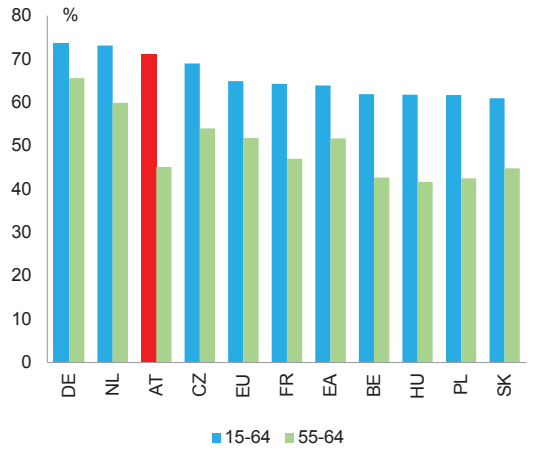


Source: Eurostat, European Commission

Labour market

Labour market conditions in Austria are better than in most EU countries, but challenges lie ahead. The unemployment rate remains at a much lower level than in most EU countries, which is equally true of youth unemployment. Labour market participation and employment rates compare favourably with both EU and euro area averages, except for older workers (Graph 1.9). Nevertheless, the Annual Growth Survey priority of balancing flexibility with security considerations in labour market policies is relevant for Austria. Unemployment is expected to decline only slowly, partly due to high net migration. The number of jobs is increasing in absolute terms, but is largely driven by the creation of low-paid and part-time jobs. Wages continue to grow at a moderate nominal rate of around 2 %. The more dynamic development in wages compared with the euro area and relatively low productivity growth in recent years are reflected in nominal unit labour costs, which — together with weaker export growth — could have a dampening impact on labour demand.

Graph 1.9: **Employment rates (15-64 years, 55-64 years, 2014)**



Source: Eurostat

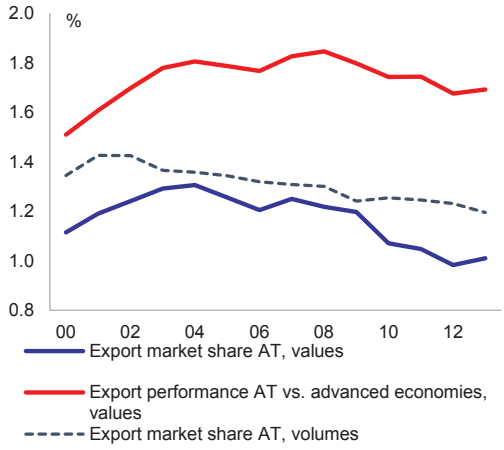
Trade

Austria's long-standing current account surplus has been declining since 2008, accompanied by a gradual loss in market share (see section 2.4.), and has only begun to recover recently. The decrease in the trade balance mainly reflects weaker demand from euro area countries. The loss in market share concerns both value and volume losses, but price effects dominate. In particular, Austria's export prices are rising more slowly than those of its trading partners. Compared with other advanced economies, Austria has been slightly losing ground in the export markets (Graph 1.10). However, the net international investment position of Austria turned positive in 2013 and could improve further as households and corporations are still in a positive net lending/borrowing position more than compensating for the government deficit.

Public finances

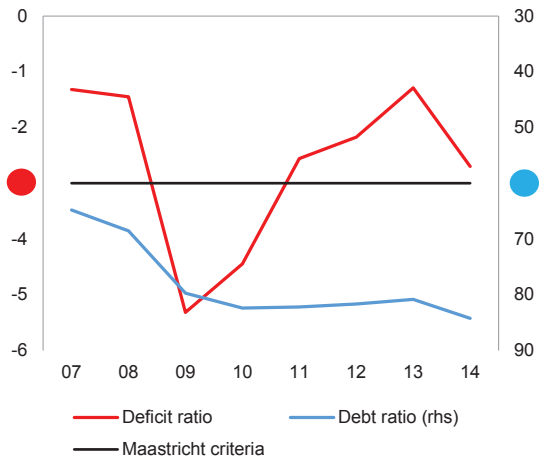
Public finances have remained sound overall, but were significantly impacted by public support to banks (see section 2.3.). The financial crisis resulted in rescue measures that are weighing heavily on public deficit and debt. Public finances were considerably affected by support given to a number of banks that experienced losses and capital shortfalls during the crisis following their strong expansion abroad. As a result, the public debt ratio increased markedly, reaching 84 % of GDP in 2014 (Graph 1.11). The increased deficit during the crisis was gradually brought below 3 % through a mix of discretionary savings and tax measures. This trend can also be seen in the structural balance, which improved after the crisis from -3 % of GDP to around -¾ % of GDP by 2014.

Graph 1.10: **Export market share (goods and services)**



Source: AMECO, Eurostat, European Commission

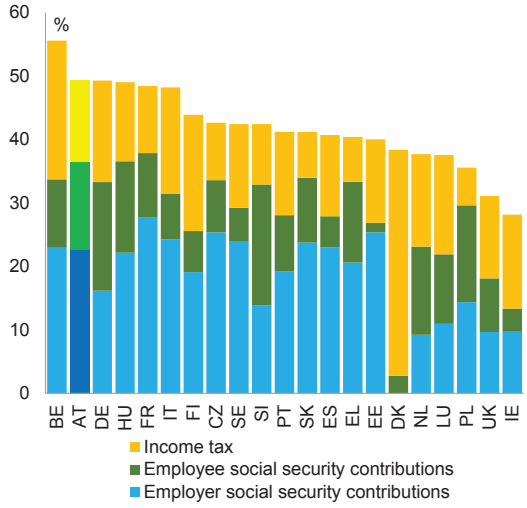
Graph 1.11: **General government deficit and debt (% of GDP)**



Source: Eurostat, European Commission

Comparatively high government expenditure is financed by a high tax burden, particularly on labour (see section 3.2.). Figures for 2014 show that Austria has a high public expenditure-to-GDP ratio (52.5 % vs 48.2 % for EU-28). Pension payments, subsidies and healthcare spending are higher than in other Member States. The higher revenue needed to finance the spending results in a high tax on labour, which puts a strain on labour supply and demand (Graph 1.12). In line with the 2015 and 2016 Council Recommendations for the euro area, the 2016 tax reform improves the situation by relieving the tax burden on labour income and contributes to an increase in labour supply.

Graph 1.12: **Tax wedge (% of labour costs, 2014)**

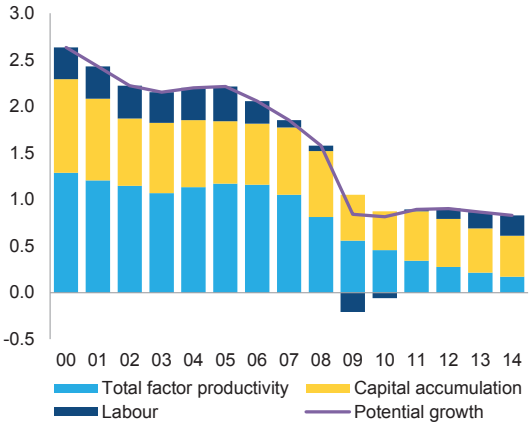


Source: OECD

Long-term sustainability

Austria's ageing society is facing considerable future challenges caused by increasing pension and healthcare payments (see section 3.3.). The statutory retirement age is low compared with other European countries, and the effective retirement age is even lower due to the widespread use of early retirement schemes and invalidity allowances. The proportion of elderly people participating in the labour market is relatively low. Along with high expenditure on healthcare, Austria is expected to face considerable challenges in maintaining long-term fiscal sustainability. The low effective retirement age implies that skilled and experienced workers exit the labour market relatively early which impairs labour supply. This, combined with declining total factor productivity, is taking its toll on potential growth. Even before the crisis, potential growth was on a downward path and from 2009 remained persistently at a low level of around 1 % (Graph 1.13). The noticeable decline in total factor productivity reflects the loss in labour productivity which led to rising unit labour costs and reduced price competitiveness.

Graph 1.13: **Potential output growth and contributions by production factors (%, pps., per year)**



Source: Eurostat, European Commission

As explained in more detail in the rest of this report, Austria is facing various challenges. Further progress in the financial sector restructuring process is a challenge, seeking to simultaneously strengthen capital buffers, improve profitability and handle risks associated with Austria's large and interconnected banking sector. With economies slowing down in emerging markets and especially in China, Austria's export industry is expected to face a challenging environment. Rising unit labour costs and weak productivity improvements could over time put its good trade performance and market share at risk. Significantly higher net migration may have a beneficial impact on Austria's labour supply in the longer term, but only to the extent labour market integration is successful. It also remains a challenge to increase the labour market participation of older workers and women.

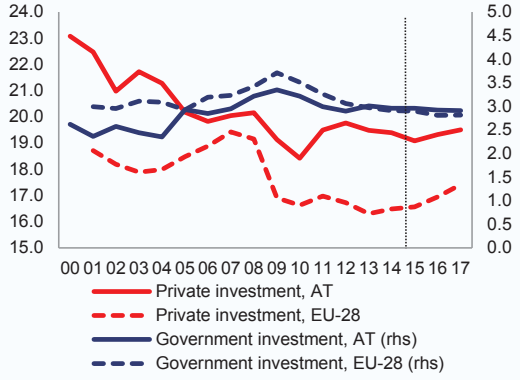
Box 1.1: **Investment challenges**

Macroeconomic perspective

The investment situation in Austria has been less influenced by economic trends than the EU-28 average. Austria's investment rate was not affected as much as the EU-28 average during the crisis years (Graph 1). Private investments declined gradually since 2000 and reached a low point during the crisis years. However, private investments also recovered quickly in 2011 and have stabilised since then. Going forward, investment activity is expected to pick up in the coming years due to improved confidence, favourable financing conditions and the need for renewal of equipment, although Austria is not expected to benefit as much as other EU partners from the expected increase in private investment until 2017. Securing progress in the structural reform priorities identified would further strengthen investment prospects. Public investment also shows a very stable pattern with government investment growing moderately in the pre-crisis years. Since then government investment has stabilised at a level comparable to the period before the crisis.

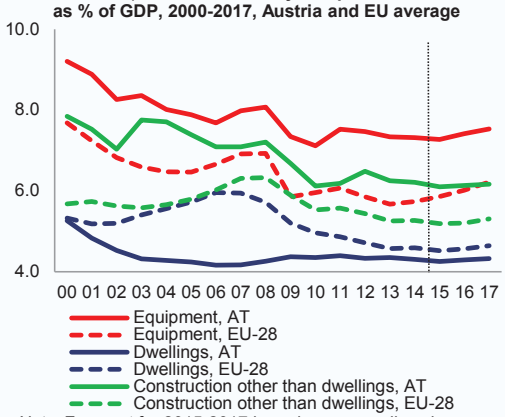
Housing investments are fairly stable whereas corporate investments are following economic trends. Austria has a higher investment rate than the EU average for all components, except for investment in dwellings (Graph 2). Investment in dwellings has remained remarkably stable, holding its level since 2003 and not much impacted by the economic cycle. Investment in equipment and other construction depends more on general economic developments and had already declined before the crisis, reaching their lowest point in 2010. Since then investment in equipment and other construction are developing at a stable rate. Growing demand in the housing sector, as well as in general, should drive investment in both construction and equipment in the coming years.

Graph 1: **Public and private investment as % of GDP, 2000-2017, Austria and EU average**



Note: Forecast for 2015-2017 based on a no-policy-change assumption
Source: European Commission

Graph 2: **Investment by components as % of GDP, 2000-2017, Austria and EU average**



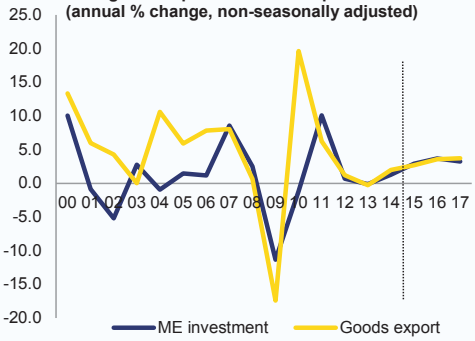
Note: Forecast for 2015-2017 based on a no-policy-change assumption
Source: European Commission

Austria's export industry drives corporate investments in machinery and equipment. Investment in machinery and equipment by corporations closely follows the trend in goods exported (Graph 3). For example, the sharp drop in goods exported during the crisis year 2009 is reflected in a similar decline in investment in machinery and equipment. This is due to the pivotal role of the Austrian manufacturing sector, which accounts for a significant proportion of investment in machinery and equipment, exports and gross value added. Its importance for the overall economy is reflected in its proportion of total economy gross value added, which has averaged 19% in the last decade without seeing a significant decline. The sector is also an important driver of investment, accounting for on average 73% of nominal investment in machinery and equipment in the last decade. Austria's export industry recovered quickly from the crisis, and although some downside risks to competitiveness exist (see section 2.4.), exports are expected to steadily increase in the coming years, triggering corresponding investments by corporations.

(Continued on the next page)

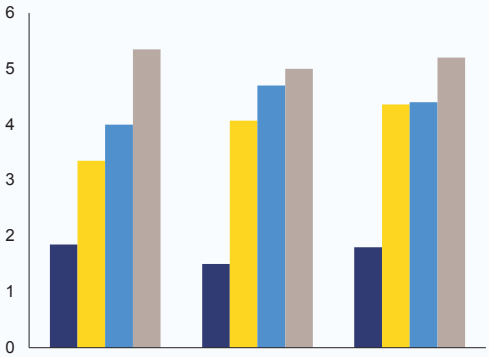
Box (continued)

Graph 3: **Machinery and equipment investment and goods exports in constant prices (annual % change, non-seasonally adjusted)**



Note: Forecast for 2015-2017 based on a no-policy-change assumption
Source: European Commission

Graph 4: **Public procurement in % of GDP**



Source: European Commission

Assessment of barriers to investment ([1]) and ongoing reforms in accordance with the second objective of the Annual Growth Survey 2016 on "Re-launching investment":

In the fields of the financial sector and taxation, Austria has made some progress and has recently implemented a tax reform taking effect from 2016 (see section 3.2.). This reform is going in the right direction by lowering the tax burden on labour, which however still remains high in comparison to other European countries. Further decreases of the tax wedge and further tax reforms more specifically targeted to benefit the corporate sector could increase investments. Also, in the field of public procurement Austria is lagging behind the EU average and could improve public investment expenditure (Graph 4). Public-private partnerships could constitute an alternative financing model if an value for money analysis confirms their superiority over other forms of procurement. By including private capital, the investment volume can be leveraged and more emphasis can be put on performance and public spending efficiency as the expected financing costs are slightly higher due to the remuneration of the private investors. An impediment to the further leveraging of public investment by including private investors consists in the lack of resources, capacity and experience on the side of the public administration for managing and risk monitoring such public-private partnerships.

Regarding public administration and business environment no progress can be seen in improving the investment environment (see section 3.5.). The regulatory barriers and the administrative burden remain high (notably the licensing and permit system), which can deter the creation of new businesses. In particular, for limited liability companies as compared with single-person companies the legal requirements are much more extensive and costly. In general, credits for investments and starting a business are available and inexpensive due to the low interest environment. However, some smaller and medium-sized companies might experience more restricted collateral conditions in access to finance.

In the area of sector-specific regulation, business services and regulated professions remain difficult to access for new service providers (see section 3.5.). No progress has been made in facilitating market access by simplifying regulation and requirements on legal form, tariffs or shareholding obligations. The opening of the services sector as well as liberal professions would not only increase investment there, but also within other sectors and industries that depend on them. Contrary to the otherwise stable investment trends in Austria and its relatively good performance compared with other EU Member States, there was a marked decline in investment for market services between 2001 and 2014 from 14% to 12% of GDP.

([1]) See "Member States Investment Challenges", SWD(2015) 400 final/2 (http://ec.europa.eu/europe2020/pdf/2016/ags2016_challenges_ms_investment_environments_en.pdf).

Box 1.2: **Contribution of the EU Budget to structural change**

Austria is a beneficiary of support from the European Structural and Investment Funds (ESIF) and can receive up to EUR 4.9 billion for the period 2014-2020. This is equivalent to 6.2% of the expected national public investment in areas supported by the ESI funds.

All necessary reforms and strategies have been put in place in order to fulfil ex-ante conditionalities in those areas to benefit from the Funds in order to ensure successful investments.

Programming of the Funds covers employment, research and development, climate change and energy, education and combating poverty and social exclusion. Following Council country specific recommendations the ESF in Austria supports both key labour market (i.e. employability of older workers, addressing the gender pay gap and the integration of young people without education or vocational training) and education and training measures (i.e. reducing the number of early school leavers of young people from groups under risk). Regular monitoring of implementation includes reporting in mid-2017 on the contribution of the funds to Europe 2020.

Financing under the new European Fund for Strategic Investments (EFSI), Horizon 2020, the Connecting Europe Facility and other directly managed EU funds would be additional to the ESI Funds. Following the first rounds of calls for projects under the Connecting Europe Facility, Austria has signed agreements for EUR 697 million for transport projects. For more information on the use of ESIF in Austria, see: https://cohesiondata.ec.europa.eu/countries/AT.

Table 1.1: **Key economic, financial and social indicators — Austria**

	2003-2007	2008	2009	2010	2011	2012	2013	2014	forecast 2015	2016	2017
Real GDP (y-o-y)	2.5	1.5	-3.8	1.9	2.8	0.8	0.3	0.4	0.7	1.7	1.6
Private consumption (y-o-y)	2.2	0.8	0.6	1.0	1.3	0.6	0.1	0.0	0.2	1.5	1.4
Public consumption (y-o-y)	1.9	3.7	2.5	0.1	0.0	0.2	0.6	0.8	0.9	0.8	0.7
Gross fixed capital formation (y-o-y)	2.1	1.4	-7.3	-2.1	6.7	1.3	-0.3	-0.2	0.7	2.6	2.5
Exports of goods and services (y-o-y)	6.1	2.3	-15.0	13.8	6.0	1.7	0.8	2.1	2.6	3.5	3.6
Imports of goods and services (y-o-y)	5.7	0.9	-12.0	12.0	6.2	1.1	0.0	1.3	2.1	3.5	3.5
Output gap	-0.1	2.1	-2.6	-1.6	0.3	0.2	-0.4	-0.8	-1.2	-0.8	-0.4
Potential growth (y-o-y)	2.1	1.6	0.8	0.8	0.9	0.9	0.9	0.8	1.1	1.3	1.2
Contribution to GDP growth:											
Domestic demand (y-o-y)	1.9	1.5	-0.9	0.1	2.2	0.6	0.1	0.1	0.5	1.5	1.4
Inventories (y-o-y)	0.3	-0.5	-0.8	0.5	0.6	-0.4	-0.5	-0.3	0.0	0.0	0.0
Net exports (y-o-y)	0.4	0.7	-2.1	1.2	0.1	0.3	0.4	0.5	0.3	0.2	0.2
Contribution to potential GDP growth:											
Total Labour (hours) (y-o-y)	0.3	0.1	-0.2	-0.1	0.0	0.1	0.2	0.2	0.5	0.5	0.3
Capital accumulation (y-o-y)	0.7	0.7	0.5	0.4	0.5	0.5	0.5	0.4	0.4	0.5	0.5
Total factor productivity (y-o-y)	1.1	0.8	0.6	0.5	0.3	0.3	0.2	0.2	0.2	0.3	0.4
Current account balance (% of GDP), balance of payments	3.6	4.5	2.6	2.9	1.6	1.5	1.9	2.0	.	.	.
Trade balance (% of GDP), balance of payments	4.5	4.7	3.6	3.0	2.3	2.4	2.8	3.7	.	.	.
Terms of trade of goods and services (y-o-y)	-0.4	-1.3	2.2	-1.8	-1.7	-0.4	0.1	0.7	1.7	0.3	0.1
Capital account balance (% of GDP)	-0.1	0.0	-0.1	-0.1	-0.1	-0.1	-0.2	-0.1	.	.	.
Net international investment position (% of GDP)	-11.4	-10.1	-5.1	-5.2	-1.9	-3.1	1.3	2.2	.	.	.
Net marketable external debt (% of GDP)1	-17.8*	-15.1	-10.8	-18.0	-20.8	-23.6	-20.0	-20.9	.	.	.
Gross marketable external debt (% of GDP)1	178.9	190.1	184.7	185.3	186.2	183.6	172.5	172.1	.	.	.
Export performance vs. advanced countries (% change over 5 years)	.	6.7*	0.1*	-6.9*	-4.5	-12.3	-10.6	-9.98	.	.	.
Export market share, goods and services (y-o-y)	4.8	-2.6	-1.7	-10.6	-2.1	-6.2	1.9	0.7	.	.	.
Net FDI flows (% of GDP)	2.1	5.0	0.3	2.0	3.6	3.2	2.4	-0.3	.	.	.
Savings rate of households (net saving as percentage of net disposable income)	10.5	11.9	11.3	9.3	7.9	9.2	7.3	7.8	.	.	.
Private credit flow (consolidated, % of GDP)	6.0	5.5	1.3	0.3	3.0	1.3	0.6	0.2	.	.	.
Private sector debt, consolidated (% of GDP)	124.2	127.5	132.8	132.8	130.1	128.9	127.6	127.1	.	.	.
of which household debt, consolidated (% of GDP)	50.5	52.5	53.9	54.8	53.5	52.1	51.2	51.4	.	.	.
of which non-financial corporate debt, consolidated (%	73.7	75.0	78.9	78.0	76.6	76.8	76.4	75.7	.	.	.
Corporations, net lending (+) or net borrowing (-) (% of GDP)	-0.4	-0.1	2.0	3.8	2.0	0.5	1.3	2.0	1.4	1.1	1.5
Corporations, gross operating surplus (% of GDP)	26.4	26.6	24.7	24.9	25.1	24.2	23.5	23.1	23.1	23.1	23.6
Households, net lending (+) or net borrowing (-) (% of GDP)	5.1	5.7	5.2	3.9	2.4	3.2	1.9	2.6	3.4	4.1	3.8
Deflated house price index (y-o-y)	0.3	-1.1	3.5	4.4	3.0	4.9	3.0	1.5	.	.	.
Residential investment (% of GDP)	4.2	4.3	4.4	4.4	4.4	4.3	4.3	4.3	.	.	.
GDP deflator (y-o-y)	2.0	1.8	1.9	1.0	1.9	2.0	1.5	1.6	1.9	1.2	1.7
Harmonised index of consumer prices (HICP, y-o-y)	1.8	3.2	0.4	1.7	3.6	2.6	2.1	1.5	0.8	0.9	1.8
Nominal compensation per employee (y-o-y)	2.4	3.3	1.6	1.1	2.0	2.7	2.2	1.7	1.9	1.3	1.6
Labour productivity (real, person employed, y-o-y)	1.3	-0.4	-3.4	1.2	1.2	-0.3	-0.1	-0.5	.	.	.
Unit labour costs (ULC, whole economy, y-o-y)	1.1	3.7	5.2	-0.1	0.8	3.0	2.3	2.3	1.8	0.5	0.9
Real unit labour costs (y-o-y)	-0.9	1.8	3.2	-1.1	-1.1	1.0	0.8	0.6	-0.1	-0.7	-0.8
Real effective exchange rate (ULC, y-o-y)	0.8	0.7	2.1	-2.2	0.1	-0.6	3.0	1.8	-1.7	-0.5	.
Real effective exchange rate (HICP, y-o-y)	0.4	0.3	1.1	-3.4	0.5	-1.8	2.1	1.7	-1.8	1.4	-0.3
Tax wedge on labour for a single person earning the average wage (%)	32.9	34.0	32.6	32.7	33.4	33.9	34.3	34.6	.	.	.
Taxe wedge on labour for a single person earning 50% of the average wage (%)	21.6*	22.7	21.0	21.2	20.9	21.7	22.3	22.7	.	.	.
Total Financial Sector Liabilities, non-consolidated (y-o-y)	12.4	1.8	-0.4	0.8	1.5	1.9	-2.3	0.9	.	.	.
Tier 1 ratio (%)2	.	7.9	9.6	10.0	10.3	11.3	11.9	12.3	.	.	.
Return on equity (%)3	.	2.3	1.2	6.6	1.2	4.5	1.0	-1.9	.	.	.
Gross non-performing debt (% of total debt instruments and total loans and advances) (4)	.	2.0	2.7	3.9	4.0	4.3	4.2	6.2	.	.	.
Unemployment rate	5.2	4.1	5.3	4.8	4.6	4.9	5.4	5.6	6.0	6.2	6.4
Long-term unemployment rate (% of active population)	1.4	1.0	1.2	1.2	1.2	1.2	1.3	1.5	.	.	.
Youth unemployment rate (% of active population in the same age group)	9.7	8.5	10.7	9.5	8.9	9.4	9.7	10.3	.	.	.
Activity rate (15-64 year-olds)	71.7	73.9	74.3	74.4	74.6	75.1	75.5	75.4	.	.	.
People at-risk poverty or social exclusion (% total	17.1	20.6	19.1	18.9	19.2	18.5	18.8	19.2	.	.	.
Persons living in households with very low work intensity (% of total population aged below 60)	14.3	7.4	7.1	7.8	8.6	7.7	7.8	9.1	.	.	.
General government balance (% of GDP)	-2.6	-1.4	-5.3	-4.4	-2.6	-2.2	-1.3	-2.7	-1.6	-1.7	-1.7
Tax-to-GDP ratio (%)	42.4	42.4	42.0	41.8	41.9	42.5	43.3	43.8	44.1	43.6	43.2
Structural budget balance (% of GDP)	.	.	.	-3.2	-2.5	-1.8	-1.3	-0.7	-0.3	-1.0	-1.4
General government gross debt (% of GDP)	66.1	68.5	79.7	82.4	82.2	81.6	80.8	84.2	85.9	85.1	84.0

(1) Sum of portoflio debt instruments, other investment and reserve assets
(2,3) domestic banking groups and stand-alone banks.
(4) domestic banking groups and stand alone banks, foreign (EU and non-EU) controlled subsidiaries and foreign (EU and nor controlled branches.
(*) Indicates BPM5 and/or ESA95.

Source: European Commission, winter forecast 2016; ECB

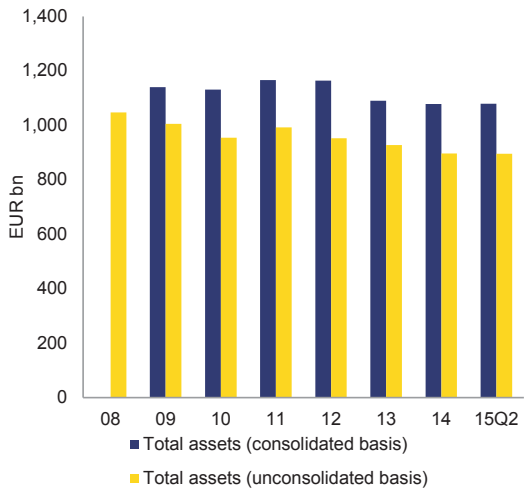
2. IMBALANCES, RISKS, AND ADJUSTMENT ISSUES

This section provides the in-depth review foreseen under the macroeconomic imbalances procedure (MIP) ([1]). It focuses on the risks and vulnerabilities flagged in the Alert Mechanism Report 2016. The section first analyses the profitability, capitalisation and funding capacity of Austrian banks in connection with domestic credit supply. Second, the section explores the exposure of Austrian banks in Central, Eastern and Southeastern Europe, including in Russia and Ukraine, also assessing the risks of potential spillovers on Austria. Third, the overall public finance costs of bank support are analysed, together with the future prospects of specific financial institutions, which have impacted on government debt and deficits. Fourth, the competitiveness of the Austrian economy is discussed, in light of some loss in export market shares in recent years. The section concludes with the MIP assessment matrix which summarises the main findings.

2.1. FINANCIAL SECTOR SITUATION AND LENDING CAPACITY

Austria has a large and internationally-oriented banking sector. Following more than a decade of rapid expansion both in Austria and internationally, the total assets of Austrian banks at consolidated level stood at EUR 1 079 billion at the end of June 2015 (Graph 2.1.1). This amounts to roughly 330 % of GDP. Excluding the assets of the subsidiaries in Central, Eastern and Southeastern Europe ([2]) (CESEE), i.e. at unconsolidated level, the total assets of Austrian banks amounted to roughly 270 % of GDP. Total banking sector assets (both consolidated and unconsolidated) remained practically flat between the end of 2014 and June 2015. Despite the large size of the banking sector, the share of the total assets of the Austrian banks as share of GDP stood below the euro area average in June 2015.

Graph 2.1.1: **Developments in total banking sector assets**



Source: OeNB, Financial Market Authority

The Austrian banking sector is one of the most fragmented in the EU, but at the same time a few banking groups play a more dominant role. Austria has a very large number of banks, yet few big players. With 748 credit institutions in September 2015, Austria is, after Germany the euro area Member State with the largest number of credit institutions. The large number of relatively small credit institutions is reflected in the low degree of concentration of the Austrian banking sector (as measured by the Herfindahl index). This reflects the importance of the cooperative banks and local savings banks sectors. However, these two sectors are dominated by two main groups: Erste Bank Group and Raiffeisen Group. Together with Unicredit Bank Austria, these three banking groups account for an important share of banking sector assets. All three banking groups are also active internationally.

([1]) According to Article 5 of Regulation (EU) No 1176/2011.

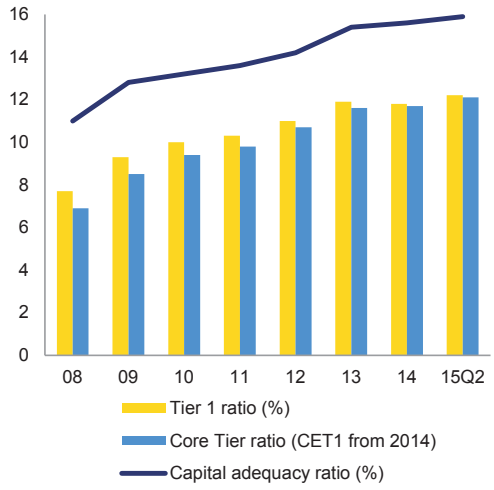
([2]) The CESEE (Central, Eastern and South-eastern Europe) region includes Turkey and the following sub-regions: i) Central and Eastern Europe (CEE), consisting of the Czech Republic, Hungary, Poland, the Slovak Republic and Slovenia; ii) Southeastern Europe (SEE), consisting of Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Kosovo, the former Yugoslav Republic of Macedonia, Montenegro, Romania and Serbia; iii) the Baltic region, consisting of Estonia, Latvia and Lithuania; Russia, Belarus, and Ukraine.

Capitalisation and profitability

The capitalisation of the Austrian banking sector strengthened further in 2015, but still remains below the average of peers. Notwithstanding recent improvements, the largest Austrian credit institutions still lag behind in comparison to EU peers. Capital adequacy, when taking into account the capitalisation of the subsidiaries in CESEE, improved steadily and reached 15.9 % at the end of June 2015, as compared with 11.0 % at the end of 2008. However, the improvement since 2013 has been only marginal. The common equity Tier 1 (CET 1) ratio rose to 12.1 % at the end of June 2015 compared with 6.9 % at the end of 2008 ([3]), but only slightly since 2013 (Graph 2.1.2). In absolute terms, the increase in core capital at system level since 2008 amounted to EUR 16 billion. The three largest Austrian banking groups still have lower capital buffers as compared with their peers and their efforts to strengthen capital buffers are focused on the reshaping of their business models and increasing efficiency. Overall, banking sector capitalisation remains among the lowest in the euro area and the reinforcement of bank balance sheets has been less pronounced so far than in other EU countries. However, the lower leverage ratios of Austrian banks as compared with their European peers reflect their focus on a more traditional banking business.

The recently introduced macro-prudential measures are expected to improve the capitalisation of the largest banks and banking sector resilience. In June 2015, the Financial Market Stability Board (FMSB) recommended that the national supervisor, the Financial Market Authority (FMA), enact a systemic capital buffer of up to 3 % of risk-weighted assets for 12 credit institutions to protect them against systemic risks ([4]). After the issuance of the FMSB recommendation, the European Central Bank determined the capital ratios under the Supervisory Review and Evaluation Process (SREP) for the same credit institutions. Since the SREP ratios are higher than initially envisaged by the FMSB, it was decided in September 2015 to limit the systemic risk buffer to 2 %. In December 2015, the FMA implemented the gradual phasing in of the systemic risk buffer. By 2019, Erste Group Bank, Raiffeisen Zentralbank, Raiffeisen Bank International and Unicredit Bank Austria will have to reach a buffer of 2 % of risk-weighted assets, whereas the other credit institutions will need to reach a buffer of 1 %.

Graph 2.1.2: **Capitalisation of Austrian banks (consolidated level, 2008–2014)**



Source: OeNB

The low profitability of Austrian banks in the domestic market has limited their capacity to generate capital internally. The profitability of Austrian banks on the local market remained resilient until 2012, but has since come under pressure. The low interest rate environment in Austria coupled with sluggish credit activity has been weighing on profitability. With the Austrian market being competitive due to the large number of credit institutions, the high cost-to-income ratio reflecting rigid cost structures and the increase in loan-loss provisions have impacted negatively on

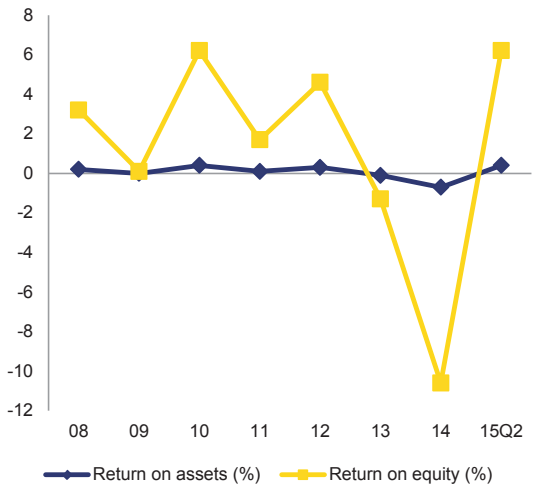
([3]) Data on capitalisation as of 2014 is based on the Basel III requirements introduced through CRD IV/CRR.

([4]) The credit institutions which will have to build up a systemic risk buffer are: Erste Bank Group, Raiffeisen Zentralbank, Raiffeisen Bank International, UniCredit Bank Austria, Raiffeisenbank Oberösterreich, Raiffeisen — Holding Niederösterreich — Wien, BAWAG P.S.K, Hypo Niederösterreich, Hypo Vorarlberg, Hypo Tyrol, Landesbank Oberösterreich and Sberbank. This systemic risk buffer of up to 3 % would include a buffer of 1 % of RWA to address the 'systemic vulnerability' of Austrian banks and a buffer of 2 % of RWA that would address 'systemic cluster risks'.

profitability. Austrian banks have higher cost-to-income ratios on the domestic market than for their operations in the CESEE region. The Austrian market is also "over-branched", as banks have continued to maintain a very dense branch network, one of the largest in Europe. Only six EU Member States (Bulgaria, Cyprus, France, Italy, Portugal and Spain) have a higher network density. Profitability of the domestic activities turned negative in 2013 and contrary to the generally prevailing situation in the euro area, the three largest banking groups operating domestically posted net losses in 2014. Return on equity at unconsolidated level remained in negative territory in 2014, but recovered in the first half of 2015. In June 2015, return on equity stood at 5.8 % as compared with -9.9 % at the end of 2014.

An important challenge going forward will be to improve the capacity of Austrian banks to generate profits in the domestic market. The low interest rate environment is expected to continue to negatively impact the capacity of banks to generate net interest income. Although most of the Austrian banks have also benefited from a decline in funding costs, their margins have come under pressure, especially for smaller banks which have a low capacity to generate non-interest income to compensate the decline in net interest income. In recent years, the withering of the profits of foreign subsidiaries, due to measures related to the conversion of foreign currency loans and the higher loan-loss-provisions in several markets including Ukraine, has contributed to the drop in profitability at consolidated level. Further efficiency improvements and cost-cutting measures in the domestic market, for instance through the reduction in the number of network branches could lead to a reduction in operational expenses and support profitability. The cost-to-income ratio of Austrian banks stood at roughly 60 % in the first half of 2015, a higher level compared with euro area and CESEE peers. The improvement in the profitability of the Austrian banks will also support their capacity to organically generate capital**.**

Graph 2.1.3: **Developments in the profitability of Austrian banks (unconsolidated level)**



Source: OeNB

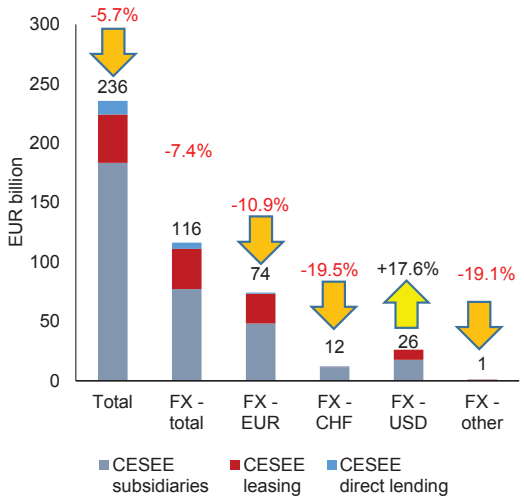
Foreign-exchange denominated loans to Austrian households also continue to represent a source of vulnerability ([5]). Swiss franc denominated loans account for roughly 96 % of foreign currency denominated loans and were very popular in Austria before 2008 ([6]). About 70 % of the total foreign currency loans granted by banks to Austrian households were bullet loans, most of them linked to repayment vehicles, i.e. an investment fund used to repay the principal of the loan at the end of the term, which are sensitive to financial market developments. Before the onset of the financial crisis, Austrian banks financed their Swiss franc denominated loans through the unsecured interbank money market and issuances of Swiss franc denominated bonds. However, with the outbreak of the crisis, the unsecured interbank money market collapsed, whereas the issuances of Swiss franc-denominated bonds stalled in 2008. However, Austrian banks have managed to gain access to the Swiss repo market and also used the bilateral repo facility between the European

([5]) In addition, even EUR denominated loans are characterised by a large share of variable-rate loans, which may induce additional medium-term vulnerability when interest rate levels normalise. Household loans in EUR were characterised by strong reorientation from fixed-rate to variable-rate loans during the 2000s, as the share of variable-rate loans among new household loans regularly exceeds 80 %. Although relevant legislation had changed in 2009, it is unclear in how far such policy levers have affected the change.

([6]) This was due to the lower interest rates, the low volatility of the Swiss franc and high demand for Swiss franc denominated products, in particular in Vorarlberg, the federal state bordering Switzerland. Roughly 70 % of the total foreign currency loans granted in Austria are loans to households, mainly mortgage loans.

Central Bank and the Swiss Central Bank, which was in place the period 2008 – 2010, to secure funding for their exposures in Swiss francs.

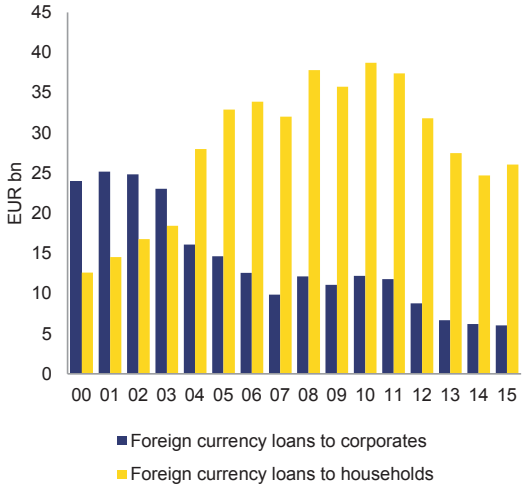
Graph 2.1.4: **CESEE credit and leasing exposure in foreign currency (Q4 2014, growth rates from Q4 2013 to Q4 2014)**



Source: OeNB, Financial Stability Report 29, Chart 21

Foreign-exchange denominated loans, in particular Swiss franc loans, have decreased. The decline in foreign exchange lending, both to households and non-financial corporations, reflects the initiatives of the Austrian banking supervisors on risk management and new lending in foreign currency adopted from 2008 onwards. Moreover, the 2011 recommendations by the European Systemic Risk Board (ESRB) aiming at curbing foreign exchange lending to unhedged borrowers had an impact. At the end of June 2015, the outstanding stock of foreign currency loans of the Austrian banks to households amounted to EUR 26 billion compared with roughly EUR 38 billion in 2008 (Graph 2.1.5). The impact on the asset quality of Austrian banks of the appreciation of the Swiss franc has been limited by the fact that most household borrowers in foreign exchange in Austria are high earners. However, according to the results of a recent survey by the Financial Market Authority and the central bank of Austria (OeNB), the aggregated borrowers' funding gap of repayment vehicle loans amounted to 14 % for households (EUR 2.8 billion) and 15 % (EUR 0.5 billion) for corporates at the end of 2014. Including the Swiss franc appreciation effects as of August 2015, the funding gap is estimated by the OeNB to have increased to roughly 21 % for households and 22 % for corporates. The last foreign currency loans will mature after 2035.

Graph 2.1.5: **Foreign currency loans to Austrian households and corporates**



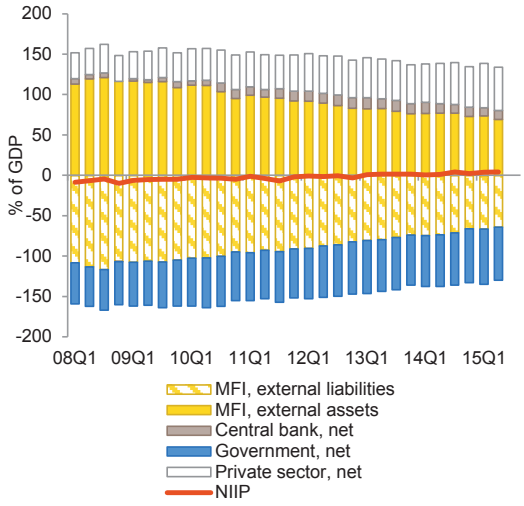
Source: OeNB

Funding capacity of Austrian banks

Austrian banks were strongly engaged in channelling foreign funding to CESEE countries, but since 2008 external funding needs have declined considerably. Consequently banks dominate Austria's gross assets and liabilities. Both increased to more than 100 % of GDP up to 2008, but have since declined to 69 % and 64 % of GDP respectively. Evidence on bilateral flows indicates that prior to 2008, Austria used funds originating from within the euro area to provide funding to CESEE subsidiaries. Reversing asset growth in 2009 coincided with a change in liabilities as non-European investors reduced their exposure to Austria sharply. While the Austrian net position remained broadly unchanged, the net outflow of debt financing to CESEE countries came to a halt. The reversal of financing by investors outside Europe in 2009 was observed throughout the EU but is particularly pronounced in Austria. As a result, foreign financing which had increased to 5.6 % of GDP in 2008 in the years prior to the crisis returned to an almost balanced position already in 2010.

Both external and internal factors have led to changing market perception and increased risk premiums in recent years. Austrian banks responded to increased risks in CESEE markets by reversing their asset growth and strengthening their capital position. Up to 2013, Austrian banks were able to strengthen their ratios not only by reducing assets, but by improving their core capital through the raising of core Tier 1 and Tier 2 instruments. The various laws and decisions taken in 2014 and 2015 as part of the restructuring of Hypo Alpe Adria have led credit rating agencies and markets to reconsider their appraisal of the government's stance towards banks. Along with the significant negative impact of developments in Ukraine of Russia on profitability, such actions were mentioned by rating agencies as a reason for the downgrading of most major banks.

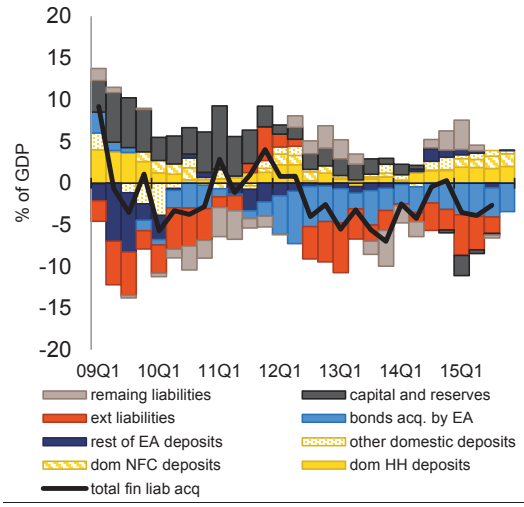
Graph 2.1.6: **International Investment Position (IIP) by sector**



Source: Eurostat

Banks have a comfortable liquidity position and are not faced with funding constraints. Domestic deposits increased more strongly after 2014 despite low interest rates. Deposits have shifted from medium-term maturities to more short-term sight deposits in view of the decline in long-term yields. This may have led to a marginal increase in liquidity risks, which explains the observed shift of banks towards liquid assets such as government bonds. On aggregate, however, Austrian banks still benefit from excess liquidity and do not seem to face funding constraints. In order to match the duration risk of long-term illiquid assets, such as mortgage loans, Austrian banks rely partly on covered bonds. Since 2014, spreads on Austrian covered bonds have increased moderately, and the issuances of such covered bonds have slowed down in line with reduced asset growth. Overall, however, there are no reported market constraints regarding covered bonds. The increased covered bond spreads may be passed on to mortgage interest rates, but do not appear to be constraining lending volumes.

Graph 2.1.7: **Monetary financial institutions (MFI) - consolidation, liabilities acquisition (Q4 moving average)**

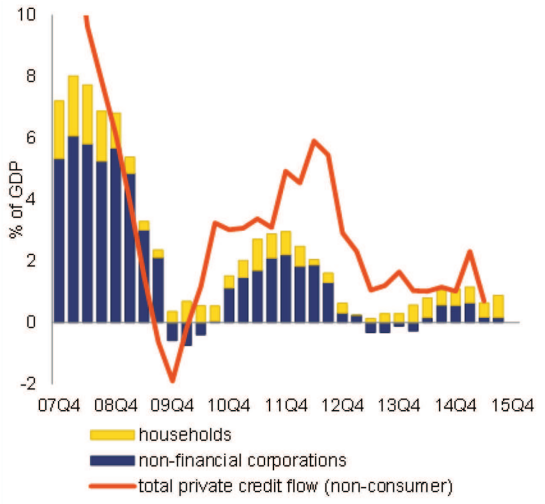


Source: European Central Bank

Some Austrian banks have been facing increased costs for subordinated debt and reduced ability for raising fresh equity. The bleak profit outlook has enticed banks to reduce dividends and other payments to investors in order to use retained earnings for strengthening their capital ratios. In addition, banks had to further focus on reducing risk-weighted assets in order to increase their capital buffers. Credit default swap spreads on junior and unsecured debt for major Austrian banks increased in 2014. They declined afterwards, but still remained at high levels. The diminished profit outlook has led to lower valuations for Austrian bank equity, which hampered further equity issues after 2014. This also resulted in Austrian banks focusing on other measures to increase capital ratios, namely reducing risk-weighted assets and cutting costs in order to increase profitability.

The reduction in bank assets went hand-in-hand with a decline in bank bonds held by foreign investors. While the initial balance sheet reduction since 2008 fell mainly on interbank loans (as in most of the euro area), the bank deleveraging since 2012 has been characterised by foreign investors scaling back their Austrian bank bonds. In that respect, the rating downgrades of several banks led to increased regulatory holding costs for euro area financial sector investors, which traditionally hold almost half of Austrian bank bonds. While banks could cushion the impact to some extent by increasing the domestic deposit base and through equity injections, total bank liabilities have continued to decline since 2012. However, the decreased external funding also reflects decreased needs, as Austrian banks reduced the funding gaps in their CESEE subsidiaries. Overall, the lower appetite of foreign investors does not seem to be a constraint on bank funding.

Graph 2.1.8: **Bank loans (flows)**



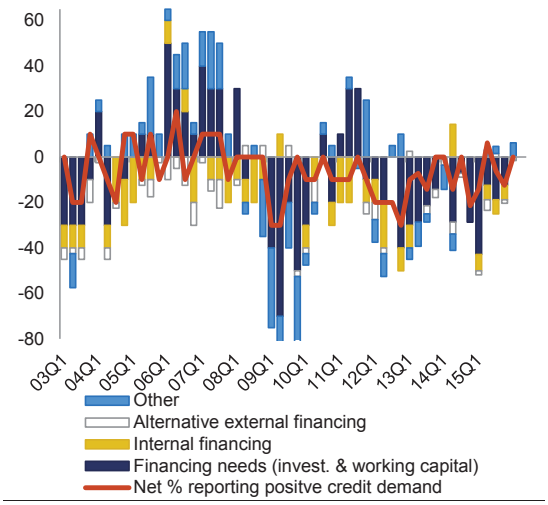
Source: Eurostat and European Central Bank

Domestic lending capacity of Austrian banks

Domestic lending remains subdued and coincides with bank deleveraging. Credit flows to the private sector has developed at slow pace since the crisis in spite of the positive contribution by households. The private debt ratio, which peaked in 2009 as a consequence of the downturn in economic growth, has gradually returned to its pre-crisis level. A breakdown by sector shows that, after a contraction in 2010 and 2011, Austrian households continued to gradually increase their indebtedness. This is also true for housing price dynamics, which have increased steadily since 2004, both in nominal and real terms, supporting a continued demand for credit. Credit to non-financial corporations has on the contrary been very muted. At the same time, household lending has remained remarkably stable, since residential property is increasingly purchased with little loan content, i.e. by households with greater financial resources. Household disposable income is expected to continue recovering in 2015-2017 and deleveraging pressures are thus set to remain limited.

Supply-side factors are not significant drivers of lending to non-financial corporations. Despite Austrian loan interest rates having been among the lowest in the euro area, new lending to non-financial corporations (NFCs) has been very muted since 2013. This has coincided with steady NFC deleveraging since 2010 (see Graph 2.1.12). Despite solid corporate liquidity and overall favourable financing conditions the NFC's investment has developed sluggishly since 2012, The 13.6 % of GDP level expected in 2015 remains close to the 2008 level. The ECB's bank lending survey highlights that demand for new credit has been muted, but supply-side factors may

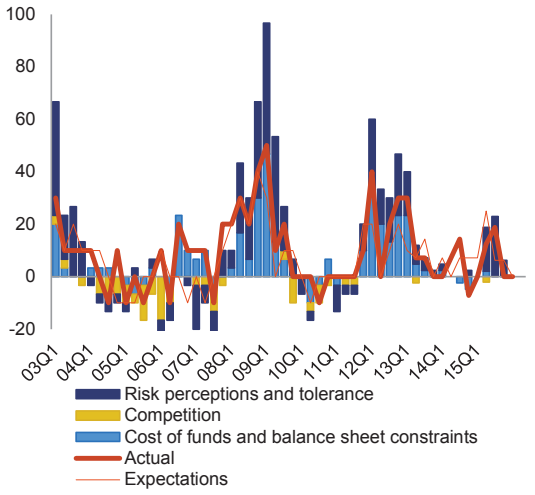
Graph 2.1.9: **Bank lending survey – demand**



Source: ECB Bank Lending Survey

have played a role. Lending standards for corporations were tightened in 19 out of 33 quarters since mid-2007. The further tightening in 2013 was linked to cost-of-funds factors, balance sheet constraints and risk perception, while the further increase in 2015 was mainly due to changes in banks' 'risk tolerance.'

Graph 2.1.10: **Bank lending survey for non-financial corporates – supply constraints**

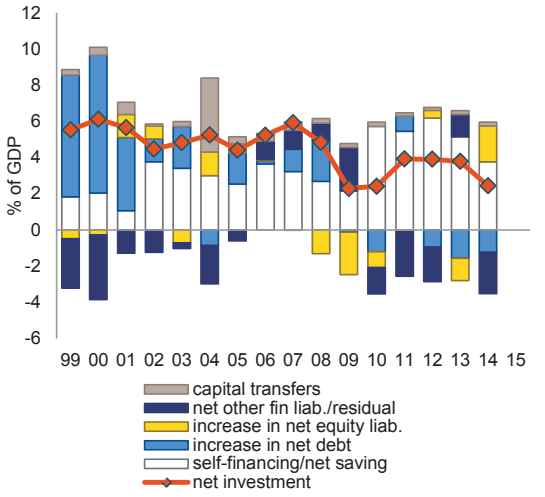


Source: ECB Bank Lending Survey

Declining firm investment coupled with the increased reliance of corporates on internal financing has reduced the demand for credit. Non-financial companies have relied mostly on internal funds to finance investment since 2010. Since 2010, firms have been relying less on external funding, and reducing their debt liabilities, a trend that intensified until 2014 (see also section 3.5.). Consequently, new firm investment now mainly relies on internal financing, as the retained earnings of companies exceed investment. Firms have thus turned from being net borrowers before 2010 to becoming net lenders since.

Credit demand seems to have been the major driver of negative credit flows. Although corporate earnings remain sound, non-financial corporations have seen a moderate but steady decline in their operating surplus since 2012. Consequently, retained earnings fell, despite dividend payouts drifting to historical lows. This trend coincided with a decline in investment. The slide in profitability of non-financial corporations, in line with the weak economic environment and still growing input costs, puts additional pressure

Graph 2.1.11: **Net investment financing by non-financial corporations**

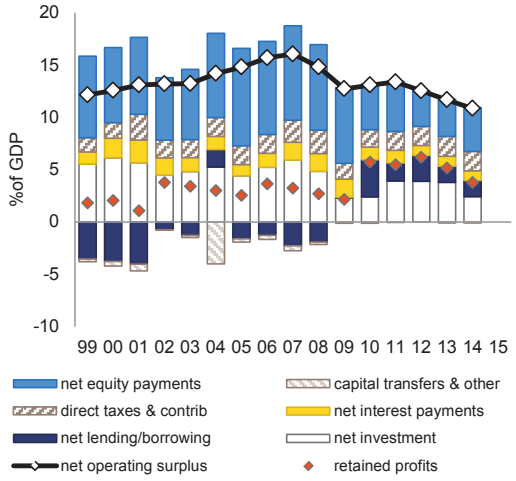


Source: European Commission, Eurostat

on the financing of new projects. According to the ECB's bank lending survey data, credit demand of non-financial corporations declined slightly in two thirds of the quarters since mid-2007. The ECB Survey on the access to finance of enterprises (SAFE) also reports falling demand of non-financial corporations for bank loans, mainly due to reduced investment needs. Overall, these and national surveys indicate that demand factors seem to be more important than supply-side factors (see also section 3.5.). Furthermore, the sector's increase of deposit holdings suggests that sufficient capacity for financing exists. On aggregate, non-financial corporation deleveraging seems to be to a large extent more due to firm-related factors. However, the aggregate position may mask more binding supply-side barriers to particular sub-sectors, in particular regarding several borrowers that may have been exposed to an increase in collateral, equity, and reporting cost requirements. Both investment surveys and the economic forecast point towards a recovery of investment in 2016, in view of stronger demand growth in Austria and key export markets. Since profits for the non-financial corporations sector are expected to stabilise at still sound levels, and the net asset position is comfortable, it is unlikely that the credit situation will be a major obstacle to investment picking up. Furthermore, until the

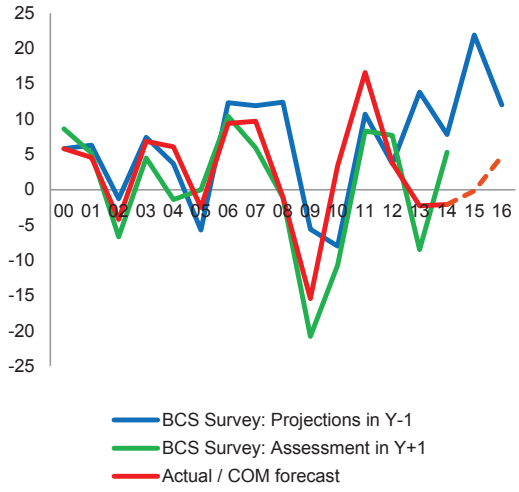
capital buffers of banks do not improve further, their lending capacity might be reduced.

Graph 2.1.12: **Non-financial corporations (NFCs) surplus redistribution**



Source: European Commission, Eurostat

Graph 2.1.13: **Findings of the ECFIN BCS Investment survey**



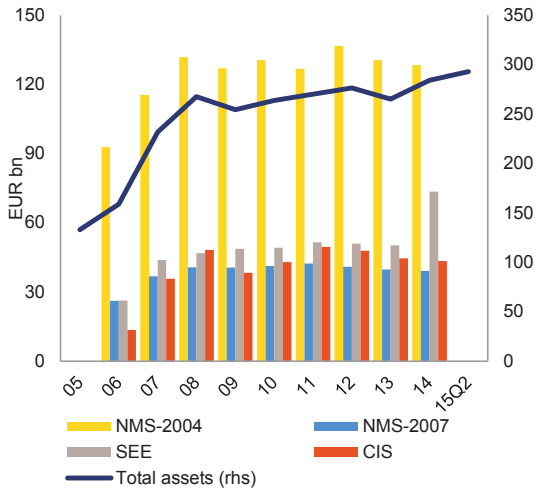
Source: European Commission

The effects of firm adjustment to the overall economy seem relatively contained so far. Firm insolvencies have remained stable, though there has been a slight increase in non-performing loans. However, weak investment is a major factor in Austria's stagnant growth in recent years.

2.2. FOREIGN EXPOSURE OF THE BANKING SECTOR

Austrian banks were among the first banks to expand to Central, Eastern and South-eastern Europe (CESEE), most markedly after the fall of the iron curtain. This expansion was prompted by several factors. First, Austrian banks aimed to provide financial services to Austrian companies with activities in the region. Second, competition on the domestic market resulted in low levels of profitability, which was a significant factor in the decision of Austrian banks to expand their operations to countries with higher growth potential and opportunities for wider profit margins. The low level of bank intermediation in CESEE as compared with Western Europe in the early 1990s, coupled with the strong growth prospects of the region, attracted the interest of Austrian banks. Third, geographical proximity and historical ties also played a major role in the decision to engage in bank intermediation in this region. At the beginning of 2000, the Austrian banks had already established themselves as key players in the banking sector of several countries in CESEE. The EU accession of several countries in CESEE in 2004 and 2007 further contributed to the expansion of operations of Austrian banks in the region.

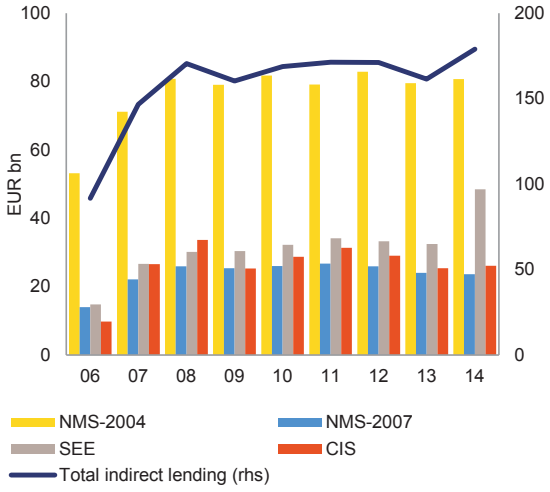
Graph 2.2.1: **Total assets of subsidiaries in CESEE**



Source: OeNB; NMS-2004: Member States which joined the EU in 2004; NMS —Member States which joined the EU in 2007

The total assets of the subsidiaries of Austrian banks operating in the CESEE region have continued to expand. The total assets of the subsidiaries of Austrian banks more than doubled between 2005 and 2015, as they increased from roughly EUR 133 billion in 2005 to EUR 293 billion in June 2015 (Graph 2.2.1). Around 60 % of the assets of the Austrian subsidiaries are located in the Member States which joined the EU in 2004 and 2007, although the total weight of non-EU assets in total assets in CESEE has increased in recent years. The total assets of the subsidiaries operating in Ukraine and Russia and other CIS countries went up steadily between 2006 and 2011, but have declined over the last couple of years due to a reduction in new activities and writing down of existing assets. The total assets of Austrian banks (in foreign and domestic ownership) operating in Russia amounted to EUR 33 billion (i.e. 11 % of the total assets of Austrian subsidiaries in the CESEE region) at the end of June 2015.

Graph 2.2.2: **Indirect lending to the private sector in CESEE and CIS**

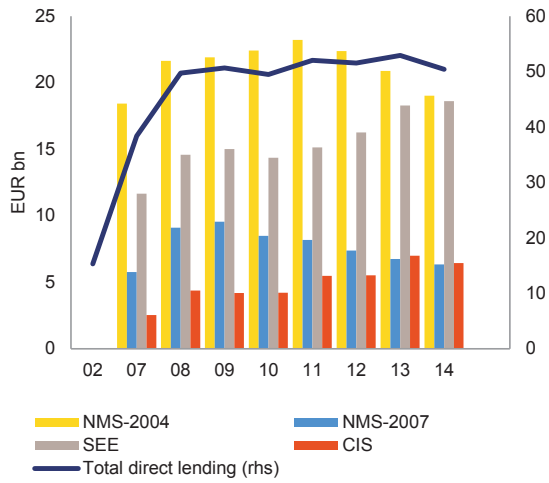


Source: OeNB; NMS-2004: Member States which joined the EU in 2004; NMS — Member States which joined the EU in 2007

Indirect lending through subsidiaries has been one of the salient features of credit provision to the CESEE region. Whereas most banks from Western Europe operating in the CESEE region contributed to the credit boom experienced by the region before 2008, Austrian banks had a higher risk appetite and expanded more aggressively in several countries in the region. An International Monetary Fund (IMF) analysis (2012) based on Bankscope data concluded that Austrian banks had expanded in line with the credit market in the

countries in Central Europe and generally slower than other banks in the Baltic region. However, Austrian banks grew more aggressively than their peers in Ukraine, Russia and the other CIS countries. Furthermore, the medium-sized Austrian banks expanded faster than the market in the countries of South-eastern Europe (SEE). Indirect lending to the CESEE region almost doubled between 2006 and 2008 (Graph 2.2.2).

Graph 2.2.3: **Direct lending to the private sector in CESEE and CIS**



Source: OeNB; NMS-2004: Member States which joined the EU in 2004; NMS — Member States which joined the EU in 2007

Direct lending by Austrian banks to the CESEE countries has remained broadly flat since 2009. Direct lending to the CESEE region has been attractive both for the largest banks and for smaller and medium-sized Austrian credit institutions. The bulk of direct lending has been represented by loans to corporates operating in CESEE. In 2008, 44 % of direct lending by Austrian banks went to the EU Member States which joined the EU in 2004, whereas roughly 29 % was provided to the SEE countries (Graph 2.2.3). Since then, total direct lending has remained broadly stable. The large majority of the direct cross-border loans granted by Austrian banks are denominated in foreign currency, mainly in EUR but also in USD and Swiss francs. Swiss franc denominated loans to corporates have been granted to several countries in the region (for instance, Croatia, Hungary and Slovenia), but to a lesser extent when compared with indirect lending.

The total exposure of the Austrian banking sector to the CESEE region has marginally declined ([7]). In the first half of 2015, the total exposure of Austrian banks (based on data from the Bank for International Settlements) to these countries was 1.1 % lower than in 2008. After the onset of the financial crisis in 2008, the Austrian banks continued to expand their operations in the CESEE region with total exposure peaking in 2011 (Graph 2.2.4). An important role in the maintenance of exposure of the Austrian banks to CESEE was played by the Vienna Initiative ([8]). Nevertheless, on the back of the deleveraging process of the euro area parent banks triggered in part by the euro area sovereign debt crisis and the sluggish growth in several countries in the CESEE region, Austrian banks gradually reduced their exposure to the region after 2011. The total exposure of Austrian banks to the region went down by 14.5 % between 2011 and 2014, but increased again in 2015. The extent of deleveraging in the CESEE region has varied between regions and countries (comparatively less decline in exposure to CIS), but has on aggregate been orderly.

The exposure to the CESEE region is fairly diversified and dominated by operations in EU Member States. Exposure to EU Member States in the CEE region outside the euro area is prominent. The core host countries for the Austrian banks have been the Czech Republic, Romania, Croatia, Hungary and Poland. At the end of 2014, the exposure to the Czech Republic, Romania and Croatia accounted for 71 % of the total exposure to the EU Member States in the CESEE region outside the euro area. The exposure of Austrian banks to the euro area Member States in the CEE region is comparatively smaller and concentrates on Slovakia and Slovenia, whereas the exposure to the Baltic countries is negligible. In the Western Balkan region, Serbia is the major market for the Austrian banks, whereas Russia is the main market in the CIS region. The exposure to Turkey has also

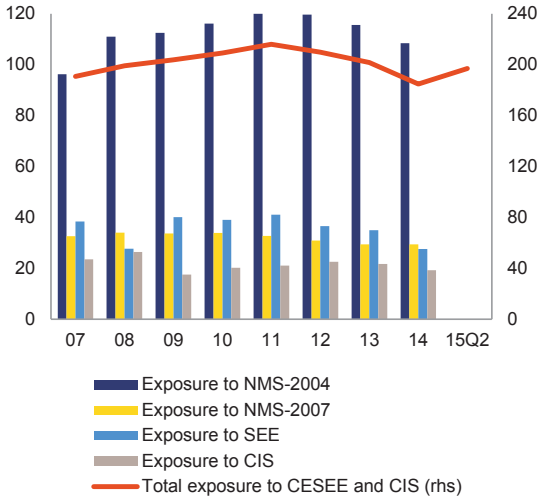
([7]) These data cover cross-border claims of banks in all currencies plus local claims of their foreign offices in all currencies. The claims include deposits and balances placed with other banks, loans and advances to banks and non-banks, holdings of securities and participations.

([8]) As a public-private cooperative action platform, the Vienna Initiative has proven to be a useful crisis management tool due to its unique composition of EC, IFIs, home and host banking sector supervisors as well as national authorities (i.e. ministries of finance).

become increasingly important since the end of 2009.

The exposure of Austrian banks to Russia and Ukraine has been large when compared with that of other EU Member States. Three Austrian banks (including foreign-owned banks) have subsidiaries in both Ukraine and Russia. However, total exposure is concentrated on two banks with operations in these two countries. In the expansion phase to these two countries, Austrian banks were attracted by their growth potential as the prospects for higher profits in other more mature banking sectors in the CESEE region had declined. In September 2015, the major domestic-owned Austrian banks had the third largest exposure to Russia after French and Italian banks, as they held 12 % of the total foreign claims (EUR 88.3 billion) of the countries in Western Europe. Furthermore, Austrian banks accounted for 24% of the total foreign claims (EUR 11.6 billion) of the countries in Western Europe to Ukraine. The exposure of Austrian banks operating in these two countries is primarily dominated by loans to the corporate sector.

Graph 2.2.4: **Consolidated foreign claims of Austrian banks (EUR billion)**



Source: Bank for International Settlements (BIS); immediate borrower basis

The exposure of Austrian banks has been in line with their commitments under the Vienna Initiative. Austrian banks have been key players under the Vienna Initiative ([9]). The Austrian and other euro area parent banks of the largest foreign-owned banks operating in the countries receiving balance of payment support (Hungary, Latvia, Romania, Bosnia and Herzegovina, Serbia) committed on a voluntary basis to maintain exposure to these countries and provide sufficient capital buffers to their subsidiaries. The Austrian banks have broadly maintained their overall exposure commitments under the Vienna Initiative and provided the necessary funding to their subsidiaries throughout the assistance programmes. This helped to maintain macro-financial stability and avert a systemic crisis during the acute phase in 2009-2010. In the second phase of the Initiative, which started in January 2012, private banks were no longer bound by exposure commitments, but agreed to avoid disorderly deleveraging in the CESEE region.

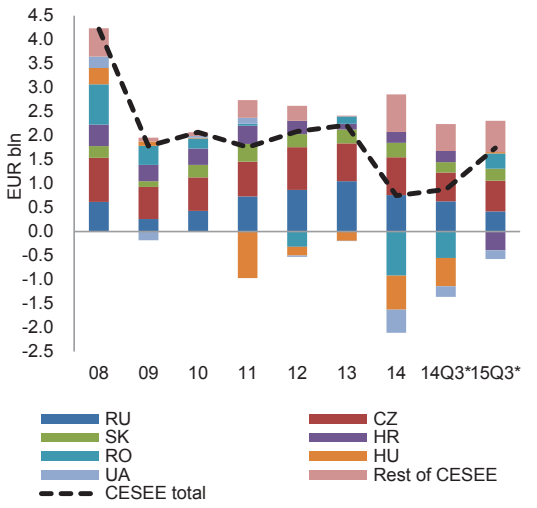
Whereas Austrian banks have a significant international exposure, banks from other euro area countries are in a similar situation. The total consolidated foreign claims of Austrian banks as share of GDP reached a peak of roughly 100 %, in 2007, but has been on a declining path and went down to roughly 68 % of GDP in 2013. Belgium and Finland have had a higher international exposure than Austria, as the consolidated foreign claims of their banks stood at 104 % and 106 % of GDP in 2013, while the share of the consolidated foreign claims of Italian, German, French and Swedish banks was lower. Although the international exposure of Austrian banks has been more diversified than, for example, the international exposure of Swedish banks, the relatively large weight of operations in the CESEE implies a relatively large scope for various spillovers. In September 2015, according to data of the Bank of International Settlements (BIS), the Austrian banks held 20 % of the total foreign claims (amounting to EUR 960 billion) of the banks in the EU-15 countries to the CESEE region, as compared with 18 % held by Italian banks,

([9]) Private sector involvement has been an important flanking measure to the balance of payment assistance granted by the EU and the international financial institutions (IMF, World Bank, EBRD, EIB) to Hungary, Latvia, Romania, Serbia as well as to Bosnia & Herzegovina in the period 2009-2011. The Austrian parent banks involved in the first phase of the Vienna Initiative were Erste Bank Group, Raiffeisen International and Volksbank (OEVAG).

17 % by French banks, 10 % by German banks and 5 % by Swedish banks.

Operations in the CESEE region have been a key source of profitability, but the profit contribution has become more uneven in recent years. Almost all operations in the CESEE region were profitable in 2008. However, several host markets (i.e. Hungary, Romania and Ukraine), which were a significant contributor to the overall profitability of the Austrian banks before 2008, have increasingly become a drag on profitability in recent years, in particular in 2014. In Romania, the non-performing loans (NPLs) resolution plan implemented by the banking supervisor to clean up bank balance sheets required a significant increase in loan-loss provisions. Furthermore, the measures related to the conversion of foreign currency loans into local currency loans adopted in Hungary and the turmoil in Ukraine contributed to the sizeable losses recorded in 2014 by the Austrian subsidiaries operating in those countries.

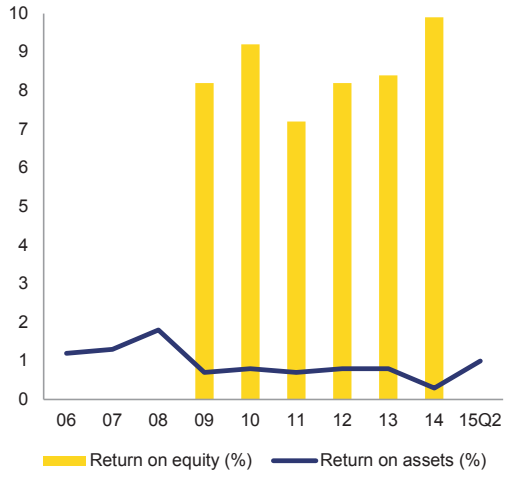
Graph 2.2.5: **Net profit of Austrian subsidiaries in CESEE (% of GDP)**



* Q3 Data not comparable with year-end data
Source: OeNB

The profits of the Austrian subsidiaries operating in the CESEE countries rebounded in 2015. Between 2008 and 2013, the overall profitability of these subsidiaries remained robust, as return on equity hovered around 8 % (Graph 2.2.6). In 2014, total profit stood at EUR 747 million, which represented a decline by 66 % as compared with 2013 and by roughly 82 % as compared with 2008. In 2014, the countries with the highest contribution to profitability were Russia, the Czech Republic, Slovakia and Turkey. The decline in profits in the markets in Central and Eastern Europe since 2008 was followed by an increase in profits stemming from Russia and Turkey. Operations in these countries, however, are subject to uncertainties induced by political risks, unfavourable economic developments and, in the case of Russia, the international commodities cycle. Overall, profitability improved in the first nine months of 2015, as the net profit of the Austrian subsidiaries in CESEE almost doubled (reaching EUR 1.7 billion) compared with the same period in 2014. In Croatia, the recently adopted measures for the conversion of Swiss franc loans into EUR loans is estimated to cause a loss of roughly EUR 700 million for the Austrian subsidiaries operating in the Croatian market.

Graph 2.2.6: **Profitability of subsidiaries in CESEE region (unconsolidated basis)**



Source: OeNB (central bank of Austria)

Operations in Ukraine have been negatively impacted by geopolitical developments. Before the onset of the Ukraine crisis, the operations of the Austrian banks in the country made a positive contribution to their overall profitability. The geopolitical developments, a challenging economic environment, the depreciation of the local currency and the ongoing deterioration in asset quality have put significant strain on the profitability of the Austrian subsidiaries. The operations of Austrian subsidiaries in Ukraine were loss-making in 2014 and the first half of 2015. In the first half of 2015,

the losses of the Austrian subsidiaries doubled in comparison with the same period of 2014. Raiffeisen International, the largest foreign lender operating in the Ukrainian market, announced in February 2015 a change in its strategy regarding this market, which includes a reduction of 30 % in exposure until 2017.

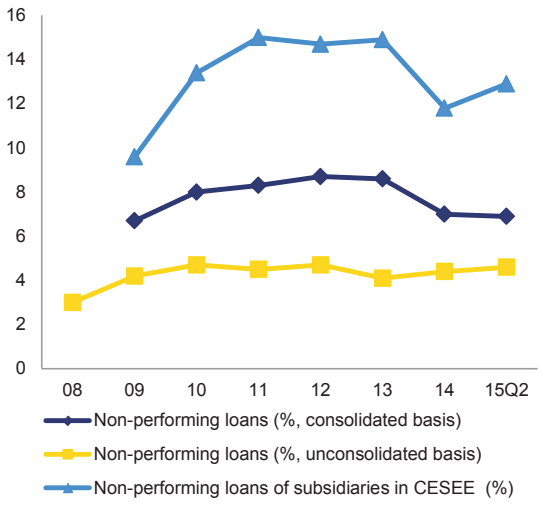
Austrian subsidiaries in Russia have been affected by the materialisation of economic and political risks. The operations of the Austrian subsidiaries in Russia have been a main contributor to overall profitability of Austrian banks at group level. Notwithstanding the deteriorating macroeconomic environment, the higher funding costs and the decline in net interest margins, profitability has remained in positive territory both in 2014 and 2015. Despite a significant reduction, profits from the Russian operations in the first half of 2015 still accounted for the second largest contribution to the aggregated net profit of the Austrian subsidiaries operating in CESEE.

Looking ahead, political and economic risks continue to constitute a main concern as regards the activities in Ukraine and Russia. Whereas the situation in Ukraine has stabilised in recent months, it requires close attention and oversight. The Austrian subsidiaries operating in Ukraine and Russia have been subject to enhanced supervisory monitoring. Considering the geopolitical and economic developments in Ukraine, the outlook for the banks operating in Ukraine remains challenging. The outlook for the banks operating in Russia also remains subdued, due to the current economic downturn and the deteriorating credit cycle. The operations in Turkey, which expanded rapidly after 2009, may be subject to some of the same type of political and economic risks.

The impact of deteriorating asset quality on profitability and capitalisation of the Austrian subsidiaries has been mitigated by supervisory action. Since 2008, asset quality has deteriorated in several core markets for the Austrian banks and has put a drag on the profitability of the Austrian subsidiaries operating in the region. The non-performing loans (NPLs) of the subsidiaries in the CESEE region increased from 9.6 % in 2009 to just below 15 % in 2013 before declining to 12 % in the first half of 2015 (Graph 2.2.7). The asset quality situation in the CESEE region has remained challenging and there is still an upward bias in the NPL ratio in several countries of the region. The decline of the NPL ratio since 2014 reflects supervisory measures taken in several countries of the region (in particular in Romania), which aim to speed up the cleaning-up of bank balance sheets as well as the restructuring of the former Hypo Alpe Adria Bank. Moreover, the Austrian subsidiaries have increased their capacity to work-out NPLs and to improve collection and recovery processes.

Asset quality still constitutes a matter of concern in several markets. Asset quality is likely to remain under pressure in several countries in the CESEE region, in particular in Ukraine and Russia. In several host countries (i.e. Croatia, Hungary, Serbia, Romania), which had a more marked deterioration in asset quality in recent years (i.e. double digit NPL ratios), the NPL ratios of Austrian subsidiaries have been on a downward trend. The NPL ratio of the Austrian subsidiaries operating in Ukraine declined in the first half of 2015, but remains at a very high level. The NPL coverage ratio (ratio of loan-loss provisions on NPLs to the volume of NPLs) of Austrian subsidiaries in the CESEE region stood at 56.3 % in the first half of 2015, by 0.5 pp. lower than at the end of 2014.

Graph 2.2.7: **Asset quality of subsidiaries in CESEE**



Source: OeNB

Despite the current downward trend, the outstanding stock of foreign currency loans granted abroad remains sizeable. A large share of the loans granted by subsidiaries of the Austrian banks operating in the CESEE region are denominated in foreign currency. Since 2008, however, foreign currency loans have declined, partly because of the more stringent measures on foreign exchange lending adopted by the Austrian supervisors. In 2010, the Austrian banks with operations in the CESEE region committed to refraining from granting new non-euro denominated foreign currency loans to unhedged households and SMEs. The total foreign currency denominated loans granted by the Austrian subsidiaries stood at roughly EUR 73 billion in the first half of 2015 as compared with EUR 84 billion in 2013. As of June 2015, the share of Swiss franc denominated loans as share of total foreign exchange denominated loans was the highest in Poland (59 %), followed by Croatia (17 %), Hungary (10 %) and Romania (4 %).

Macro-prudential measures to address the expansion of foreign currency lending in CESEE during the boom phase had mixed success. Confronted with a credit boom and an increase in foreign exchange lending by Austrian and other banks from Western Europe, especially in the period 2003-2008, several countries in the CESEE region adopted measures including of macro prudential nature which aimed to address the risks associated with foreign currency lending ([10]). After the onset of the financial crisis, the countries in the CESEE region intensified their efforts to contain foreign exchange lending, in particular, lending in currencies than EUR and implemented the 2011 recommendations of the European Systemic Risk Board (ESRB) on foreign exchange loans.

Going forward, foreign currency loans, in particular the stock of Swiss franc loans, still constitute a source of vulnerability and require close monitoring. Whereas the risk associated with Swiss franc denominated loans to Austrian households appears manageable so far, the foreign currency denominated loans granted in the CESEE region constitute an important pocket of vulnerability. Several countries in the region have already adopted or are in the process of adopting measures aimed to convert foreign currency denominated loans, in particular Swiss franc denominated loans, into local currency loans at unfavourable terms for banks. The appreciation of the Swiss franc in early 2015 has put pressure on the loan repayment capacity of some borrowers in several CESEE countries (i.e. Croatia, Poland, Hungary, Romania).

Supervisory measures have contributed to the improvement of the funding structure of the Austrian subsidiaries in CESEE. In the absence of sufficient local funding sources, partly as a result of the low savings rates in several countries in this region, parent funding sustained the rapid expansion of credit in these countries before the onset of the financial crisis. Against the background of the deleveraging process in recent years and the supervisory measures for the operations of the largest Austrian banks with international activities adopted by the FMA and OeNB in 2012 (supervisory 'sustainability package') ([11]), the funding structure of the Austrian subsidiaries has improved significantly. As part of the monitoring of the funding situation of the CESEE subsidiaries, the loan-to-local-stable-funding ratios (LLSFR) of the foreign subsidiaries have been closely monitored by banking supervision. Subsidiaries with LLSFR in excess of 110 % have been considered exposed and subject to more enhanced monitoring ([12]). At the end of June 2015, the monitored subsidiaries had sustainable LLSFRs (i.e. below 110 %). Due to the decrease in the funding gap, the loan-to-

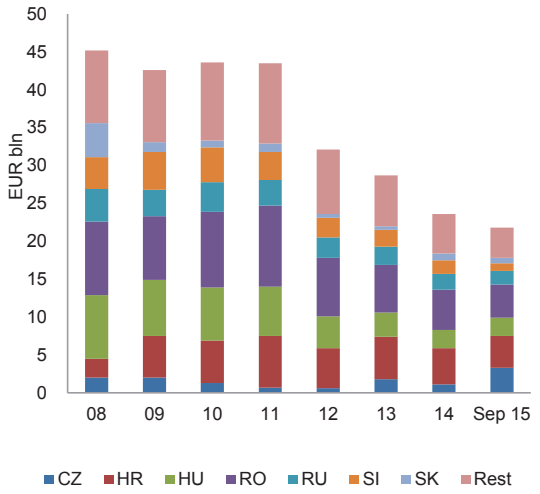
([10]) For instance, these measures included: *(i)* higher minimum reserve for foreign exchange liabilities (Romania and Serbia); *(ii)* higher loan-loss provisions for foreign currency loans (Romania and Serbia); *(iii)* higher risk weights for foreign currency loans (Serbia); *(iv)* lower loan-to-value ratios for foreign currency loans (Poland); *(v)* lower debt-to-income ratios for foreign currency loans (Poland and Romania); *(vi)* cap on the maximum ratio of foreign currency loans to capital (Romania); *(vii)* quantitative restrictions on the share of mortgage loans denominated in foreign exchange (Hungary).

([11]) Supervisory guidance on the strengthening of the sustainability of the business models of the internationally active Austrian banks, 14 March 2012.

([12]) The LLSFR (stock measure) was defined as the ratio of total loans to non-banks (net of provisions) to the sum of deposits from non-banks, funding from supranational institutions, capital from third parties, and securities with original maturities of at least one year issued to investors outside the bank's group. The LLSFR is also a tool aimed at preventing excessive credit growth in the future, while reducing the need for deleveraging during downturn periods.

deposit ratio of the Austrian subsidiaries operating in CESEE declined steadily from 109 % in 2009 to 93.9 % in June 2015.

Graph 2.2.8: **Intra-group liquidity transfers to CESEE subsidiaries (% of GDP)**

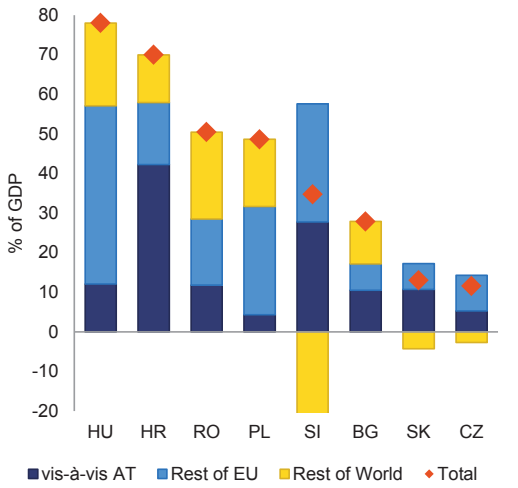


Source: OeNB
Note: Liquidity transfers to credit institutions only.

The exposure abroad of Austrian banks, coupled with their foreign currency lending, implies a potential for inward spillovers via credit, currency and political risks. In addition to credit and currency risks, activities in Russia and Ukraine appear prone to political risks, unfavourable economic developments and the international commodities cycle. Some repercussions may be difficult to decisively address by supervisory action. Furthermore, the deterioration in asset quality in several markets has not peaked yet and may continue to put strain on profitability. The large but declining stock of foreign currency loans in Austria and several CESEE countries, still constitutes an important legacy problem that requires close attention. Austrian banks may also continue to be impacted by legislative initiatives in the CESEE with unwarranted negative effects on their profitability.

The large exposure of Austrian banks to the CESEE banking sectors makes them possible transmission levers for shocks. The foreign activities of Austrian banks make them one of the largest contributors to the external financing of CESEE countries (see Graph 2.2.9). Due to the large exposure to CESEE, Austrian banks play a strong role in the diffusion or containment of economic shocks in the region. The literature on the role of foreign-owned banks emphasises the stabilising role that these banks have in the event of a crisis in the host country ([13]). Meanwhile, empirical analysis also shows that the financial situation of banks in their home country can have a strong impact on the level of credit granted by their foreign subsidiaries ([14]). In line with these findings, developments in the consolidated claims of the Austrian banking sector since 2008 suggest that the efforts of the Vienna Initiative to avoid the disorderly deleveraging of foreign players in CESEE have been successful, although the deleveraging has intensified somewhat since 2011 (see Graph 2.2.8), in line with the adjustment pressure on domestic parent banks. Deleveraging has been more pronounced in Bosnia & Herzegovina, Montenegro, Hungary and Croatia (Graph 2.2.10).

Graph 2.2.9: **Importance of Austria in the net foreign debt of selected Member States**



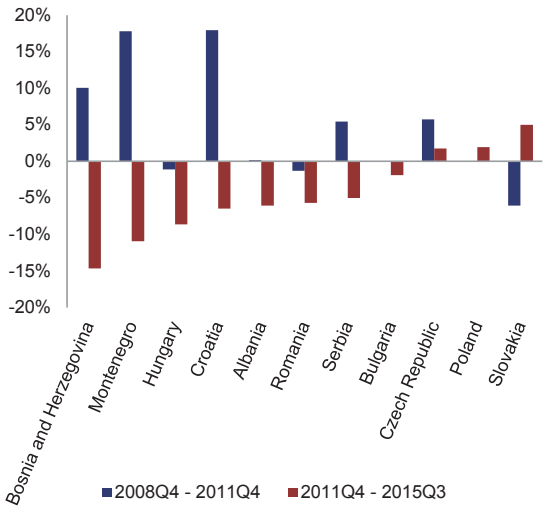
Source: Hobza and Zeugner (2014), 'Current accounts and financial flows in the euro area', Journal of International Money and Finance, No 48.

([13]) De Haas, R. and van Lelyveld, I. (2011), 'Multinational banks and the global financial crisis. Weathering the perfect storm?', EBRD Working Paper N° 135, EBRD, London.

([14]) De Haas R and van Lelyveld, I. (2006), 'Foreign banks and credit stability in Central and Eastern Europe. A panel data analysis', Journal of Banking and Finance, vol. 30(7).

Austria played a major role in funding the current account deficits of several CESEE countries. Austrian lenders account for the bulk of net foreign liabilities of Slovenia and Croatia as well as other Western Balkan states, and for a significant share in five other Member States. During the pre-2008 boom lending by Austrian banks to their subsidiaries played a major role in funding the large current account deficits and thus the strong private sector debt increases in these economies. Likewise the reduction in Austrian funding coincided with the turning of deficits into surpluses in the post-crisis bust that followed in several countries. With the exception of Bulgaria, the reduction in debt inflows from Austria to the EU Member States in the CESEE region appears comparable, though stronger, than the overall retrenchment in private sector funding. Croatia is the most striking case, as, Austrian banks funded most of the Croatian current account deficit before the crisis. Hypo Alpe Adria alone had a market share of 35 %, and thus had a major stake in the strong increase of private sector debt in Croatia until 2007.

Graph 2.2.10: **Change in exposure of Austrian banks as a % of recipient countries GDP**



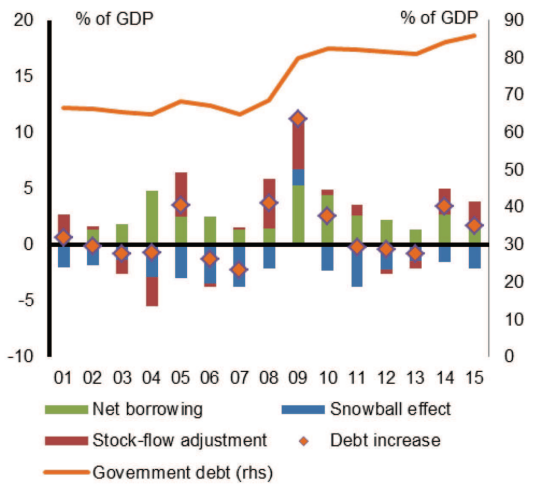
Source: BIS consolidated data on an ultimate risk basis, European Commission, World Bank
Note: Missing data for Albania in 2011 was interpolated

The decline in parent funding for subsidiaries has continued in a diversified manner and broadly reflects host country characteristics. With the onset of the crisis, Austrian banks strongly reduced their funding flows to CESEE countries, but broadly maintained their existing exposures. The policy of improving the local stable funding ratio, i.e. encouraging deposits vs loans, coincided with the relatively fast current account and demand adjustment in the CESEE countries that had lived through the most pronounced credit booms.

2.3. FINANCIAL SECTOR SPILLOVERS ON PUBLIC FINANCES

Austria's public finances have performed well overall. During the 10 years preceding the financial crisis, Austria took advantage of the good economic times and pursued a counter-cyclical policy of budget consolidation. While a larger fiscal effort could have been envisaged in order to put the government debt ratio on a descending path, the headline deficit (net borrowing) remained contained. The large deficit in 2004 was duly corrected (Graph 2.3.1). In the pre-crisis period, government debt remained broadly stable around 65 % of GDP. Positive GDP growth and declining interest rates generated a steady fall in the government debt ratio, which counterbalanced the debt-increasing effect of the headline deficits. In 2009, and again in 2014-2015, however, government debt shifted upwards. These developments, which brought Austria's public debt away from the 60 % of GDP threshold, were to a large extent due to bank support measures.

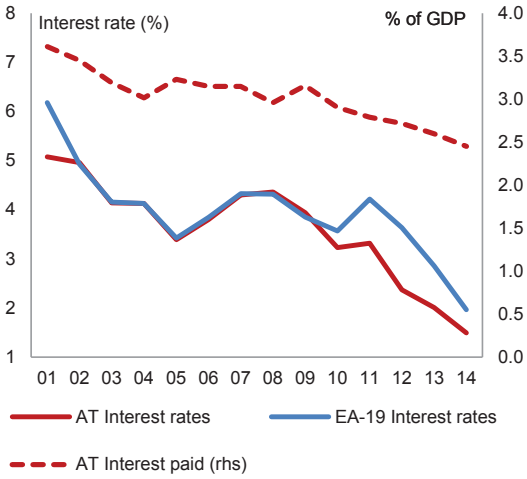
Graph 2.3.1: **Headline balance and government debt**



Source: European Commission

Austria has benefited from the declining interest rates of its long term government bonds. In line with other EU Member States, the lower financing cost has had a tangible impact on interest expenditure (Graph 2.3.2). Interest expenditure paid has reflected the declining trend of interest rates and led over a decade to lower public expenditure of around 1 % of GDP. The sharp increase in the government deficit in 2009 did not stop interest expenditure from falling.

Graph 2.3.2: **Interest expenditure and interest rates**



Source: European Commission

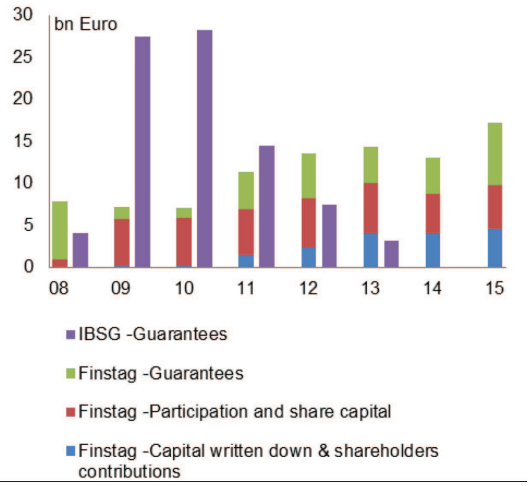
Interest rates for Austrian sovereign bonds declined faster than the euro area average, which was driven up by adjustment programmes for some Member States. A significant part of the increase in government debt was caused by the inclusion in government accounts of impaired assets from financial defeasance structures ([15]), which do not cause interest expenditure.

In response to the crisis, several Austrian banks received public support in the form of recapitalisations, guarantees and other measures aimed at preserving financial stability. Initial measures immediately after the onset of the crisis were based on a bank support scheme, which the European Commission approved under State aid rules in December 2008. The main pillars of the scheme were two laws, the Interbankmarktstärkungsgesetz (IBSG, law on enhancing inter-bank markets) and the Finanzmarktstabilitätsgesetz (FinStaG, law on enhancing stability of the financial market). The IBSG, with an initial budget of EUR 75 billion (26 % of 2008 GDP), contained two main instruments: a state-guaranteed clearing bank with

([15]) Financial defeasance structures are financial institutions created by the government for winding down the non-marketable segments of nationalised banks. Impaired assets of non-viable nationalised banks are taken over by financial defeasance structures created *ad hoc*, and divested over time. Their balance sheets are recorded as part of government debt.

the goal of renewing trust in the interbank market, and the possibility of state guarantees for securities issued by other financial institutions. Between 2008 and 2013 federal government guarantees were granted under the IBSG to support seven credit institutions operating in Austria. The credit institutions did not need to call on the guarantees, which expired by June 2014. The FinStaG had an initial budget of EUR 15 billion (5.1 % of 2008 GDP) and provided mainly for the recapitalisation of individual financial institutions, the provision of loans, and guarantees of bank assets and liabilities. The support scheme was extended four times. In July 2013 the FinStaG budget was raised to EUR 22 billion, of which roughly EUR 17 billion has been used so far. The FinStaG is still an active facility.

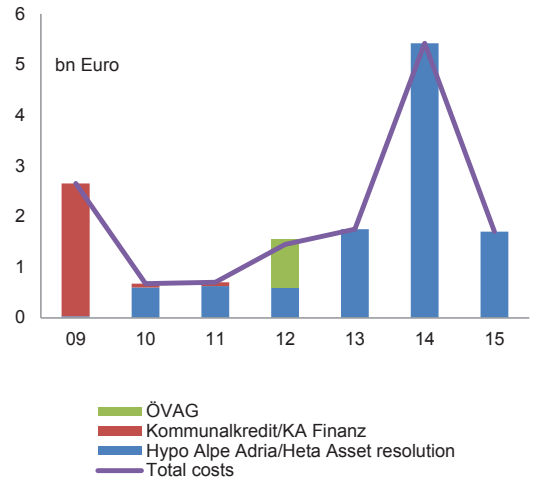
Graph 2.3.3: **Utilisation of IBSG and FinStaG**



Source: Ministry of Finance, Statistik Austria

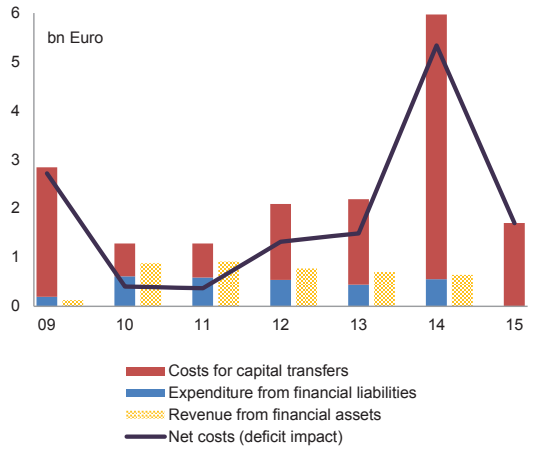
Support for Austria's banking sector relates mainly to measures dealing with three ailing banks. The market-based bank support measures put in place immediately after the onset of the crisis, allowed a number of viable financial institutions to overcome the crisis. However, the business model and the asset quality of three other major Austrian banks - Hypo Alpe Adria, Kommunalkredit and Österreichische Volksbanken – presented problems too great to be resolved with market-based measures (see Box 2.3.1) and over the years have produced a significant cumulative impact on public finances (Graph 2.3.4). To avoid the risk of adverse effects on financial market stability, the impaired assets of Kommunalkredit and Hypo Alpe Adria were put into wind-down. This involved the creation of two asset management companies ('bad banks'), respectively KA Finanz in 2009 and HETA Asset Resolution in 2014. These defeasance structures took over all non-marketable impaired assets of the two institutions. The balance sheets of KA Finanz and HETA were consolidated within the general government sector, impacting on government debt, from 2009 and 2014 respectively. The main impact on the deficit arises from the difference between the assets and liabilities of the defeasance structures included in the government accounts, based on the valuation of assets. The final effect on debt will depend on how impaired assets are progressively divested, i.e. depending on the price at which they are sold compared with the value at which they were transferred to the asset management companies. Österreichische Volksbanken (ÖVAG) was partly nationalised in 2009. Despite supporting measures, ÖVAG did not recover sufficiently and was eventually put into wind-down (see Box 2.3.1).

Graph 2.3.4: **Capital transfers recorded as deficit increasing**



Source: Eurostat, Ministry of Finance, Statistik Austria

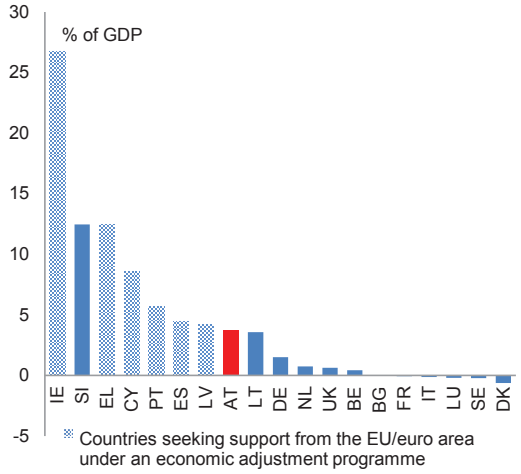
Graph 2.3.5: **Net costs for support to the financial sector**



Source: Eurostat

The impact on public finances of supporting the banking sector has been significant. While the overall increase in Austria's public debt during the crisis is among the lowest in the euro area, the net cost for financial sector measures (Graph 2.3.5) was significant. This reflected the relatively large size of Austria's banking sector in general and the support provided to the three banks in particular. The total net cost can be estimated at EUR 13.5 billion over 2009-2015, which arose exclusively from the three nationalised/partly-nationalised banks. Importantly, a large part of the cost and the reason for the protracted impact on public finances can be attributed to one institution, Hypo Alpe Adria. In the years 2013-2015 alone, the costs for this institution amounted to EUR 8.8 billion, equivalent to 2.8 % of 2015 GDP. The net cost (i.e. the deficit impact) is first calculated as the difference between the value of the liabilities of the financial institutions assumed by the government and the economic value of the impaired assets acquired by the government. Other kinds of deficit increasing transfers – less sizable - are also included. To this are added the financing costs (interest paid) and then the revenue arising from the support (guarantee fees, dividends and interest received) is subtracted. The net cost incurred was not far from some of the Member States worst affected by the economic and financial crisis. In the case of Austria, however, the challenge for public finances of supporting the banking sector did not lead to a wider loss of market confidence. Due to the sound economic fundamentals and the credentials of its fiscal policy performance in the pre-crisis period, Austria was able to shoulder the cost of bank support measures. They were implemented with the aim of preserving financial stability and restructuring or winding down banks that had an unviable business model. Moreover, the estimate of net costs does not take into account revenues collected from the bank levy, introduced in 2011 in order to share with the financial sector some of the losses imposed to public finances. The bank levy, originally intended as a temporary measure, is still in place and led to the collection of around EUR 2.7 billion in revenue between 2011 and 2015.

Graph 2.3.6: **Net costs of support to the financial sector over 2008-2014**



Source: Eurostat

Box 2.3.1: State aid and the nationalisation of three Austrian banks

The global financial crisis, which became acute in September 2008, put a strain on the Austrian banking sector. Several Austrian financial institutions received State aid mainly in the form of market-based measures under the Austrian bank support scheme. Due to serious problems which could not be resolved with measures under the bank support scheme alone, three major Austrian banks required additional restructuring measures. These institutions – Hypo Group Alpe Adria (HAA), Österreichische Volksbanken, and Kommunalkredit – needed additional State aid and were nationalised completely or partially.

Hypo Alpe Adria was nationalised as a result of its aggressive and risky expansion into Southeastern Europe which ultimately failed. At end-2008 HAA's balance sheet amounted to EUR 43.3 billion. Its expansion was fuelled by cheap funding obtained through guarantees by the regional government of Carinthia on HAA's bond issuances. Carinthia had guaranteed liabilities of HAA with – at peak level – a face value of EUR 23.7 billion, until such guarantees became illegal in 2007 at the request of the European Commission. Currently, guaranteed bonds with a face value of roughly EUR 11 billion remain. From 2002 to 2006, HAA made profits every year except for 2004. However, the business model masked underlying risks of asset quality deterioration and refinancing. HAA was sold to Bayerische Landesbank (BayernLB) in 2007. In December 2009, Austria took over the bank from BayernLB through an emergency nationalisation.

As part of the restructuring plan, all marketable segments of HAA were divested. By a decision dated 3 September 2013, the Commission declared the State aid provided by Austria to HAA as compatible with the Treaty. The aid comprised recapitalisations, guarantees, asset guarantees and potential future measures amounting to EUR 13.2 billion (4.1% of 2013 GDP). In turn, Austria committed to ensuring that HAA would implement a restructuring plan, which included the divestment of HAA's marketable entities and the winding-down of the remaining assets. The marketable entities comprised primarily the Austrian activities (Hypo Alpe-Adria-Bank AG, HBA) and the banking network in Southeastern Europe (SEE network). In May 2013, HBA was sold to the Indian banking group Anadi Financial Holdings. In July 2015, the SEE banking network was sold to a consortium consisting of the American private equity fund Advent International and the European Bank for Reconstruction and Development.

The rest of HAA was put into wind-down, with a significant impact on public finances. The wind-down segment comprised all assets which were not part of marketable entities, grouped into a financial defeasance structure named HETA. Following the application of ESA 2010 methodology, HETA's balance sheet was included into government accounts, increasing government debt by EUR 13.8 billion (roughly 4% of 2014 GDP). A preliminary asset review estimated the deficit-increasing impact at around EUR 4 billion (1.2% of 2014 GDP), i.e. the difference between the total value of liabilities to be repaid and the fair value of the assets according to the asset review. The same year, additional support provided to HETA increased the government deficit by EUR 1 billion. The Italian subsidiary HBI, still holding an Italian banking license, was also in wind-down.

The wind-down of HETA still presents several uncertainties, which may lead to savings or additional fiscal costs. In March 2015 – after a further asset review revealed additional losses of up to EUR 3.6 billion (1.1% of 2015 GDP) and the government decided to not provide further support to HETA – the Austrian Financial Market Authority (FMA) imposed a moratorium on the liabilities (interest payments and principal) of HETA until May 2016. The FMA, which is also the Austrian resolution authority, will use the debt moratorium period to conduct an independent evaluation of HETA's assets and to propose a resolution plan, which may involve the use of the bail-in as a resolution tool. While the independent asset valuation may lead to either a lower or a higher impact on public finances than currently estimated, the use of the bail-in tool would reduce final costs for the Austrian taxpayer. At the current stage it remains uncertain how the resolution will deal with the guarantees issued on part of HETA's debt by the province of Carinthia. In December 2015, the federal government has offered a loan to Carinthia via the federal debt agency, which

(Continued on the next page)

Box (continued)

together with the proceeds from winding down HETA's assets formed the basis of an offer to the creditors of HETA to buy back the debt covered by the province's guarantees.

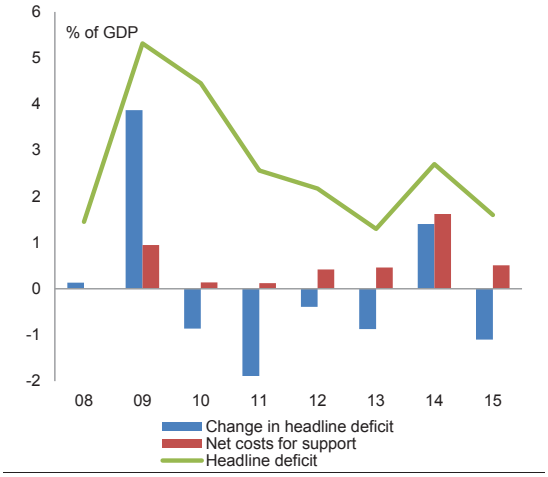
Österreichische Volksbanken (ÖVAG) was partly nationalised in 2009. ÖVAG was the central institution of the Austrian Volksbanken Group, a network of regional banking cooperatives. At the end of 2008, ÖVAG was the 4th largest bank in Austria with a balance sheet of EUR 52.9 billion. Primarily due to excessive risk-taking over the course of its expansion in Eastern Europe, ÖVAG requested State aid after the onset of the financial crisis and received EUR 1 billion in participation capital from the Austrian state under the bank support scheme in April 2009, giving the state a 43.3% stake in the bank. Austria claimed that ÖVAG was a viable bank. The Commission came to the conclusion that ÖVAG was not viable and requested a restructuring plan for the bank. The plan, approved by the Commission in September 2012, included a reduction of ÖVAG's balance sheet, behavioural commitments, and the commitment to end non-core activities, which included divesting a number of subsidiaries.

Despite the support measures, ÖVAG did not recover sufficiently and was put into wind-down. In October 2014, the European Central Bank stress test revealed a capital shortfall of EUR 865 million for the Volksbanken Group, including ÖVAG. To make up for the shortfall, the bank and the Austrian authorities devised a plan with three cornerstones: (i) Transfer of ÖVAG's functions as central institution of the Group to another bank in the Group, (ii) ÖVAG would return its banking license and be put into wind-down, under the new name Immigon, and (iii) a restructuring of the Volksbanken group, merging the 51 individual Volksbanken into eight bigger regional banks and two specialised institutes. The Commission accepted the new restructuring plan through an amendment decision on 2 July 2015. The other banks of the Volksbanken Group had to agree to repay to the Austrian state in the coming years the remaining EUR 300 million in state participation (out of 1 billion in state participation capital given in 2009).

Kommunalkredit had to be nationalised in 2009 due to its credit default swap (CDS) short positions and funding difficulties. At the end of 2008, Kommunalkredit Austria was the 7th largest bank in Austria with a balance sheet of EUR 37.4 billion. Following an uncontrolled expansion of its securities portfolio and CDS activities, the bank was negatively impacted by the financial crisis. At the end of 2008, KA recorded EUR 2.8 billion of impairment/value losses translating into a negative result of EUR 1.45 billion. Furthermore, the bank relied on funding long-term assets – mainly loans to the public sector – with cheap short-term funding. When this source of financing dried up as a result of the crisis, Kommunalkredit needed State aid and was nationalised on 3 November 2008. After the nationalisation, Kommunalkredit was split into a bad bank ("KA Finanz") and a good bank ("KA Neu"). KA Neu received State aid amounting to EUR 1.69 billion through a recapitalisation, a non-refundable loan, and an impaired asset measure. In addition, the state issued guarantees for the bank's bonds amounting to EUR 5.5 billion and an emergency liquidity assistance (ELA) amounting to EUR 5.3 billion. ELA measures were never drawn and were definitively withdrawn as of March 2009. The Commission declared the aid compatible by a decision on 31 March 2011. The main element of the restructuring plan contained in the decision was the privatization of KA Neu, which was supposed to happen by end-2012.

The wind-down of KA Finanz produced a significant impact on public finances in 2009 and affected government debt still in 2015. Similarly to HETA, KA Finanz is a financial defeasance structure including the impaired assets of the former Kommunalkredit for winding down. Its balance sheet of roughly EUR 16 billion (5.5% of 2009 GDP) was recorded as part of the government debt and generated a deficit impact of EUR 2.6 billion (1% of 2009 GDP). However, Austria did not manage to sell KA Neu. Consequently, KA Neu was also put into wind-down by way of an amendment decision on July 2013 with the option of selling up to 50% of its assets in a single deal. In September 2015, Austria sold parts of KA Neu comprising assets of approximately EUR 4 billion (about 10% of the 2008 balance sheet of Kommunalkredit). The remainder of KA Neu, i.e. EUR 6.7 billion (roughly 2% of 2015 GDP), was transferred to KA Finanz for wind-down, increasing government debt accordingly.

Graph 2.3.7: **Change in headline deficit and net costs for support to the financial sector**

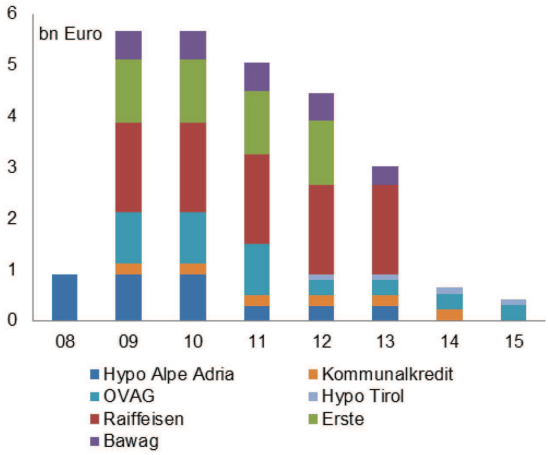


Source: European Commission

Support for the banking sector has been an important driver of the headline deficit, in particular in 2014 and 2015. As an effect of the economic crisis, in 2009 the headline deficit increased by just under 4 % of GDP, of which around one quarter was due to bank support measures (Graph 2.3.7). In 2011-2013, owing to a policy of fiscal consolidation, the deficit fell steadily, but support for the financial sector had a deficit-increasing impact, making overall consolidation more difficult. In 2014, the Austrian authorities adopted a more decisive approach regarding Hypo Alpe Adria's legacy problems, the flipside of that approach being that the measures taken caused the headline deficit to increase to 2.7 % of GDP in 2014.

Several Austrian banks have repaid the public support they received. Under the FinStaG, seven banks received support in the form of participation and share capital, mainly in order to contain liquidity problems and to meet regulatory capital requirements (Graph 2.3.8). The support represented an advance payment and was not recorded as deficit increasing, but was included in government debt. The effect on government debt is decreasing as the capital support received by banks is paid back. This form of bank support accounted for 2 % of GDP over 2008-2015. In August 2013, Erste Group finished repaying EUR 1.2 billion in state participation capital. In March 2014, Bawag P.S.K. (Bawag) repaid the last of EUR 550 million it had received in participation capital. Raiffeisen Bank International finished repaying EUR 1.75 billion in state participation capital in June 2014. The repayment of participation capital partly explains why Austrian banks have been slower to build capital buffers than their European peers.

Graph 2.3.8: **Stocks of participation and share capital**



Source: Eurostat, Ministry of Finance, Statistik Austria

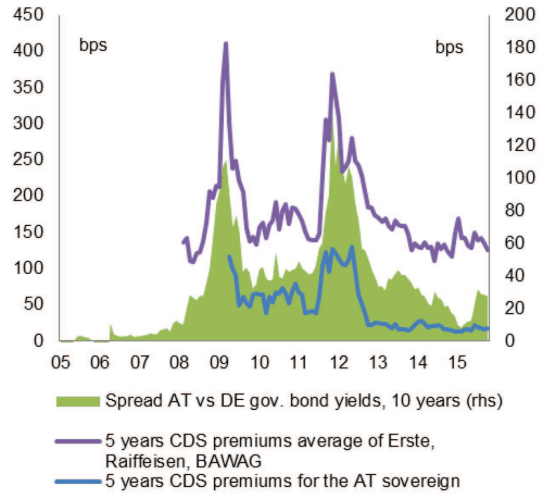
Public support for capital has been virtually phased out. From the peak of the crisis years and until 2014-2015, both the total support granted and the number of institutions in need of support were contained (Graph 2.3.8). Moreover, the support is today effectively limited to benefiting financial defeasance structures. This is a sign that the temporary nature of the banking sector support has been preserved and has played its role in helping support active market-viable banks to overcome the financial crisis.

Revenues arising from supporting the financial sector have offset the direct financing costs. The support for the banking sector did not lead directly to an increase in interest expenditure. The State aid given to banks was based on State aid rules on adequate remuneration to the government for the risks taken. In most cases, the risks did not materialise. As a shareholder in financial institutions, provider of loans and issuer of guarantees on financial assets, the Austrian government received different types of financial revenue, such as dividends, interest and guarantee fees. Erste Group reported it had paid EUR 448 million in dividends for participation capital to the

state (a 37.3 % rate of return). Bawag reported EUR 234 million (a 42.6 % rate of return), and Raiffeisen Bank International reported EUR 700 million in dividends paid (a 40.0 % rate of return). Every year from 2010 to 2014, revenues from the commitment in the financial sector more than offset the interest paid on the additional debt issued to cover the net costs of the support (Graph 2.3.5).

Financial sector risks affected somewhat the premium on Austrian sovereign bonds, but it has normalised in recent years. In the years preceding the crisis, the government bond spread to Germany was minimal. Vulnerabilities of Austrian banks coupled with uncertainty about the potential size of government exposure to the financial sector caused the interest spread of Austrian versus German sovereign bonds to increase. After a second peak in 2012, the spread versus German bonds has progressively narrowed. Austria's implementation of the Bank Recovery and Resolution Directive on 1 January 2015 contributed to further reducing the spillovers from Austrian banks to sovereign bond risk premiums.

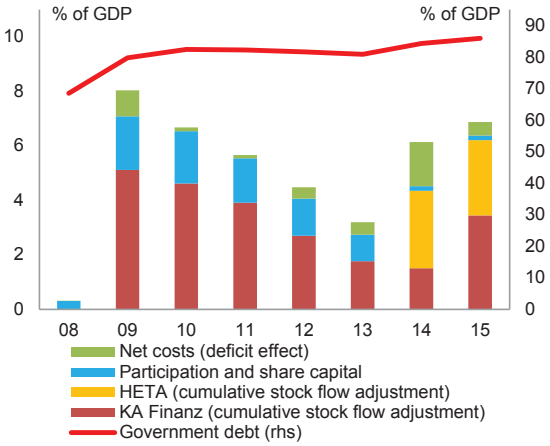
Graph 2.3.9: **Spread Austrian versus German government bond yields and 5 years CDS premiums average of three major Austrian banks**



Source: Central Bank of Luxembourg, Datastream

Since 2014, the risk premium on Austrian private banks and sovereign bonds has decoupled significantly (Graph 2.3.9). This can be interpreted as a sign that the market no longer assumes that the government is implicitly liable for Austrian banks. The increase in Austrian long-term bond yield spreads in the second quarter of 2015 corresponds to similar developments in comparable Member States.

Graph 2.3.10: **Effect on debt of financial sector support**

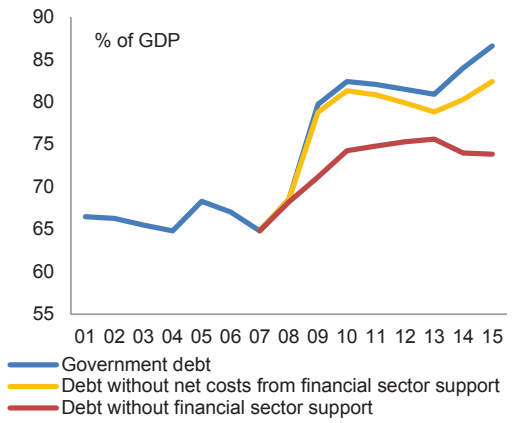


Source: European Commission, Eurostat, Ministry of Finance, Statistik Austria

Between 2009 and 2015, government support for the financial sector accounted for a total increase in public debt of around 16 % of GDP. When considering that part of the impaired assets has already been divested and that capital was partly paid back, the current impact on debt is of the order of 10% of GDP. In 2009, in particular, support for the financial sector led to an increase in government debt of 8 % of GDP (Graph 2.3.10). Public debt arising from the net losses resulting from the support amounted to 4.2 % of GDP between 2009 and 2015. The effect on debt arising from state participation and share capital provided to active financial institutions was of a similar magnitude. Most of this capital has already been repaid. The main impact on public debt stems from the impaired assets of financial defeasance structures, notably the impaired assets of HETA and KA Finanz. As these assets are only gradually being divested over time, some further impact on public finances may occur in the years to come. Without the significant impact of these defeasance structures on public debt, or had these wind-down vehicles been established at an earlier stage,

Austria's public debt ratio would most likely have peaked several years ago (Graph 2.3.11).

Graph 2.3.11: **Government debt with and without support to the financial sector**



Source: Eurostat and Ministry of Finance

Despite the significant costs, the use of bank support measures in line with EU State aid rules helped to restructure the Austrian banking sector and preserve financial stability. The provision of public support has enabled banks which were fundamentally viable, such as Erste Group and Raiffeisen, to overcome market turbulence after the onset of the financial crisis. For the institutions that were partly or fully nationalised because they were considered to be systemically important — Hypo Alpe Adria, Österreichische Volksbanken and Kommunalkredit — the measures taken were costly in terms of the impact on public finances but they successfully contributed to preserve financial stability and ensure an orderly wind-down. These banks are still subject to monitoring by the Commission decisions under State aid rules.

Regulatory and macro-prudential requirements at EU and national level have reduced the risk of additional negative spillovers to public finances. In recent years, the efforts to build additional capital in line with the requirements of the Capital Requirements Regulation (CRR) and Directive (CRD IV) and the macro-prudential capital buffers enacted by the FMSB (see section 2.2.) are strengthening the Austrian banking sector. From January 2016, the full application of the Bank Recovery and Resolution Directive requirements will also help shield public finances from significant new costs relating to bank recapitalisation and wind-down vehicles. In this regard, the amount of EUR 700 million included in the 2016 budgetary plan for bank support measures is a precautionary buffer and does not relate to any particular planned financial sector operation.

Looking ahead, while some risks remain, they appear confined to the process of dealing with legacy issues in specific banks. Overall, public support for the financial sector has been considerable, but it has enabled viable financial institutions to weather the crisis and prevented the disorderly bankruptcies of banks that were found not to be based on a viable business model. The remaining risk factors relate mainly to the winding-down process for specific banks. The large amount of impaired assets from financial defeasance structures still included in government accounts represents an element of uncertainty for public finances. Ultimately, the net costs for the Austrian taxpayer will depend on the divestment of these assets, the value of which is inevitably sensitive to the economic environment, not only in Austria but also in the wider euro area. However, it is expected that there will be little or no further impact on the deficit, while the impact on public debt will be limited by the fact that the bank balance sheets have already been fully recorded in the government accounts. Risks for the future therefore mainly relate to the continued impact on public finances of legacy issues in relation to specific institutions, while the continuation of the overall restructuring of Austria's banking sector is advancing without the need for further support from public finances.

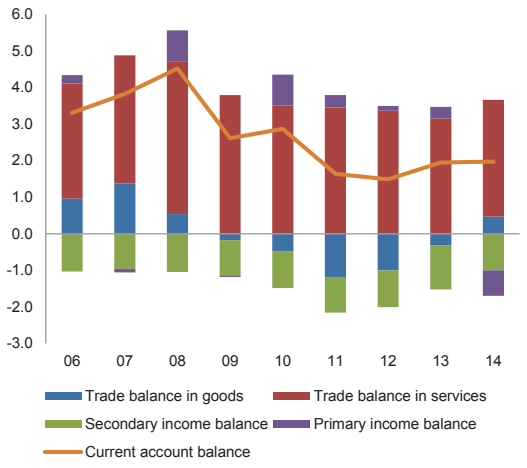
2.4. TRADE PERFORMANCE

Goods trade balance and market share

After more than a decade of improvement, Austria's current account balance has been narrowing to a moderate surplus since 2008. Austria's current account deficit gradually narrowed in the 1990s, turned to a surplus in 2002 and has remained positive ever since. However, after reaching a peak of close to 5 % of GDP in 2008, it has gradually declined and has stood at around 2 % since 2011 (Graph 2.4.1). According to the MIP scoreboard headline indicator, the three-year average Austrian current account balance between 2012 and 2014 was 1.8 % of GDP. In 2015, the surplus is estimated to have widened and is projected to remain above 3 % in 2016 and 2017.

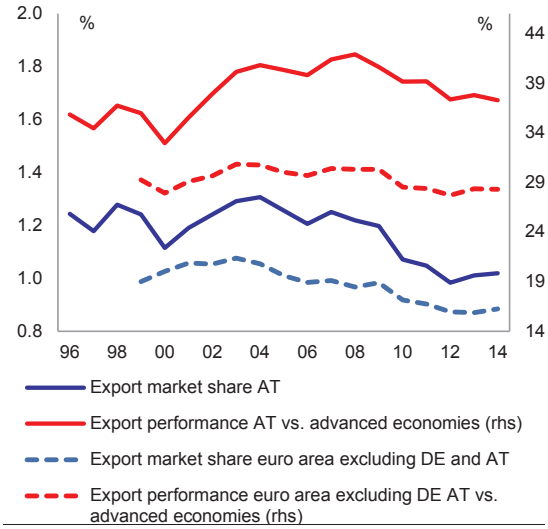
The declining current account surplus is not at first sight a cause for concern, but it has been associated with a fall in Austria's export market share. Austria's export market share was broadly stable between 1995 and 2007 and even increased compared with advanced economies. However, since 2008, the trend in both the market share and the relative performance reversed (Graph 2.4.2).

Graph 2.4.1: **Current account balance (% of GDP)**



Source: Eurostat

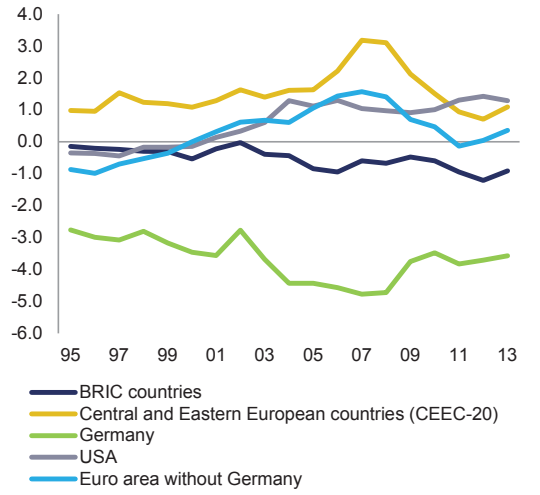
Graph 2.4.2: **Export market share (goods and services): Austria and the euro area**



Source: Eurostat, AMECO, WTO (2014 world trade), European Commission

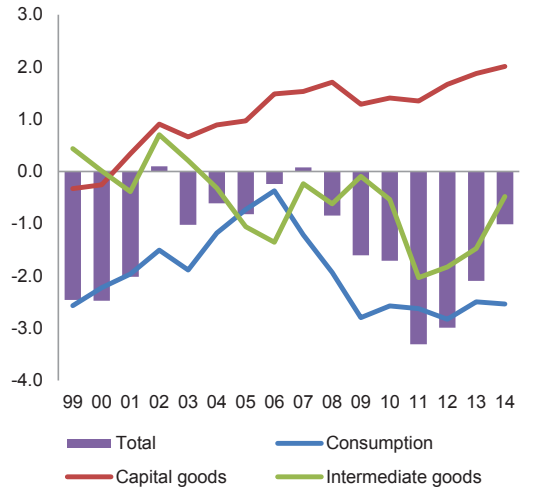
Over a decade on from the mid-1990's, Austria became increasingly integrated in world trade and successfully diversified geographically and in terms of product structure. Austria took advantage of the expansion of global trade from the mid-1990's onwards and significantly increased its trade openness. Austria's share of exports and imports as a proportion of GDP increased by about 10 pps. (to just under 40 % of GDP), a similar increase to that in Germany. While the euro area remained the primary destination for exports, Austria also rapidly expanded its exports to Central and Eastern Europe (CEE) countries, China, Russia and the US. Machinery and transport equipment were consistently the main export products and one of the largest generators of Austria's growing trade surplus, but the trade balance in manufactured goods increased significantly between 2000 and 2008. The improvement of the trade balance with CEE countries before the crisis was mainly due to increasing net exports of capital good (Graphs 2.4.3 and 2.4.4).

Graph 2.4.3: **Trade balance in goods vs main trading partners (% of GDP)**



Source: Eurostat

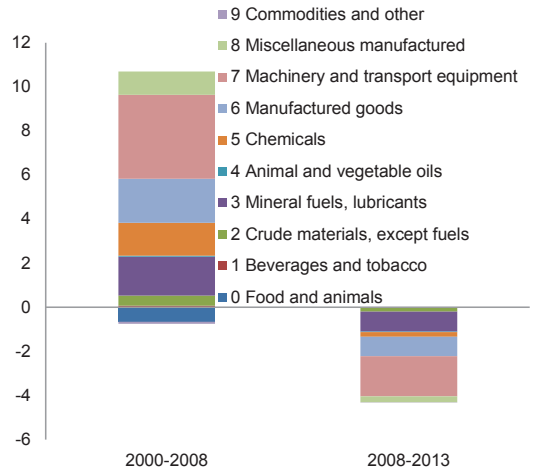
Graph 2.4.4: **Trade balance by Broad Economic Categories (% of GDP)**



Source: Eurostat

In the pre-crisis years, Austria strengthened its integration into international value chains and followed an export-led growth model. In the 2000s, Austria's exports to and imports from Germany increased significantly, reflecting the country's growing integration into German manufacturing and production processes. In particular, Austrian imports of manufactured goods and machinery and equipment from Germany began rising rapidly. This coincided with a surge in Austrian exports from these two export categories to the CEE countries. Manufactured goods and machinery and equipment accounted for the major part of Austria's growing trade surplus with these countries (Graphs 2.4.5 and 2.4.6). Estimates based on the World Input-Output Tables (WIOT ([16])) indicate that Austria was adding an increasing share of value to the products of its key trading partners in the euro area (Germany, Italy, France, and the Netherlands) and leading world manufacturing powers, such as the US, Japan and China. In the case of Germany this increase in value added was 38 % between 2000 and 2008. However, since the EU accession countries were still in the early stages of catching up with advanced countries, the value added that Austria contributed to their products was declining. Nevertheless, Austria benefited from their growing demand, owing to its position in the international supply chain. Its foreign-trade driven value added (the value added attributable to foreign final demand) increased from 31 % to 36 % between 2000 and 2008 and the accession countries played an important role in that.

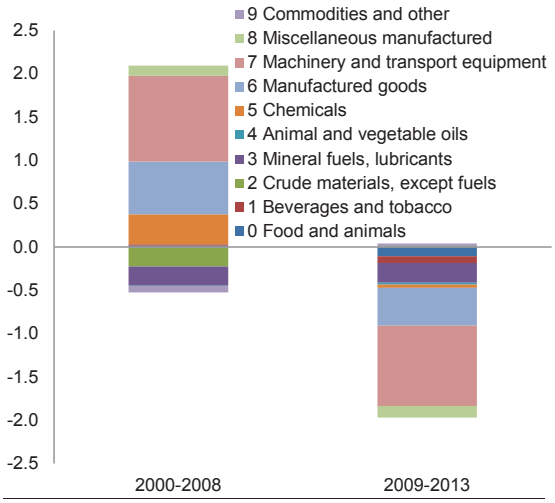
Graph 2.4.5: **Change in Austria's imports from Germany (% of GDP)**



Source: Eurostat, European Commission

([16]) See Timmer, M. P., Dietzenbacher, E., Los, B., Stehrer, R. and de Vries, G. J. (2015), 'An Illustrated User Guide to the World Input–Output Database: the Case of Global Automotive Production', Review of International Economics, 23, 575–605.

Graph 2.4.6: **Change in Austria's trade balance vs CEE countries (% of GDP)**



Source: Eurostat, European Commission

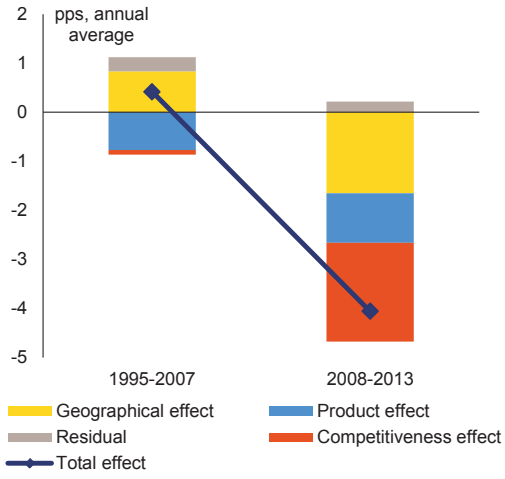
After 2008, these trends reversed. The trade deficit with Germany declined and the trade surplus with CEE and the rest of the euro area narrowed, which might indicate falling competitiveness. The reduction of the bilateral surplus with the euro area (excluding Germany) is essentially a result of the deterioration of the trade balance with Italy and Spain, matched by a reduction in all major Austrian export product categories to these countries, matching their declining demand during the crisis. The deterioration of the trade balance with CEE countries is mainly due to lower net exports of manufactured goods and transport equipment. A reduction in Austrian imports of the same goods also explains the narrowing of Austria's trade deficit with Germany at the same time. While these two developments have partly offset one another, the combined Austrian trade balance with CEE and Germany fell by almost 1 % of GDP between 2008 and 2013, effectively offsetting the improvement between 2000 and 2007. While this might reflect lower economic growth in those countries, it could also indicate that Austria's competitiveness is declining, which would partly explain the country's gradual reduction in export market shares since 2008. Trade data that supports this hypothesis is available, but covers only a limited time period. Estimates based on the World Input-Output Tables suggest that, in 2011, EU accession countries' products contained, on average, 20 % less Austrian-generated value added than in 2008. The share of Austrian value added attributable to final demand by EU accession countries declined from 3.9 % to 2.9 % of total Austrian value added over the same time period. The corresponding decline for Germany was more contained (from 6.5 % to 5.8 %) and Germany remains Austria's most important trading partner by far. At the same time, Austria significantly expanded its trade links with some countries outside Europe (e.g. China and Brazil) and maintained the intensity of its trade links with others (such as the US, Japan, Australia, Turkey, Russia and India). This enabled it to limit the overall weakening.

Constant market share analysis ([17]) shows that the decline in Austria's market share was owed to both geographical specialisation and competitiveness issues. The export specialisation towards the euro area and the CEE explains a large part of the decline in market share over the 2008-2013 period, as these two markets grew more slowly than oversea markets and therefore contributed less to Austrian export growth (Graph 2.4.8). The analysis also shows that the lower demand growth of Austria's main trading partners does not fully explain the decline in Austria's market share, and that price and non-price competitiveness aspects are also partly responsible for the deterioration (Graph 2.4.7). However, the competitiveness effect is a residual in the analysis and should therefore be complemented by a dedicated analysis of price and non-price competitiveness.

([17]) Constant market share analysis helps investigate the reasons behind a change in export market share. The analysis attributes the change of a country's market share to three different factors: (i) *A market distribution effect* that measures the effect stemming from the geographical breakdown of, in this case, Austria's exports: if Austria exports a larger share to markets where demand is growing, the value of the market distribution effect will be positive; (ii) *A product composition effect* that captures the influence of the product specialisation on Austria's exports: if Austria specialises in products for which foreign demand is growing, then the product composition effect will have a positive influence; (iii) *A competitiveness effect* which shows trends in Austrian exports compared with world exports (excluding effects stemming from geographical and product specialisation). This effect gives information about Austria's ability to increase its market share on the basis of price and non-price competitiveness factors. A positive value indicates a competitive advantage of Austria's exports compared to the rest of the world.

Austria's strong specialisation in manufactured products provided less of a boost to exports after 2008. Product specialisation in manufactured goods boosted Austria's exports in the 2000s but it was also a key contributor to the decline in market share after 2008, along with reduced exports to CEE countries and owing to low- and medium-tech goods. However, a breakdown of the product effect by sector shows that its negative contribution to changes in market share can be largely explained by the mineral fuels sector, in which Austria does not specialise. If this sector had been excluded, the overall product effect would still have been positive in the period after 2008 (Graph 2.4.9).

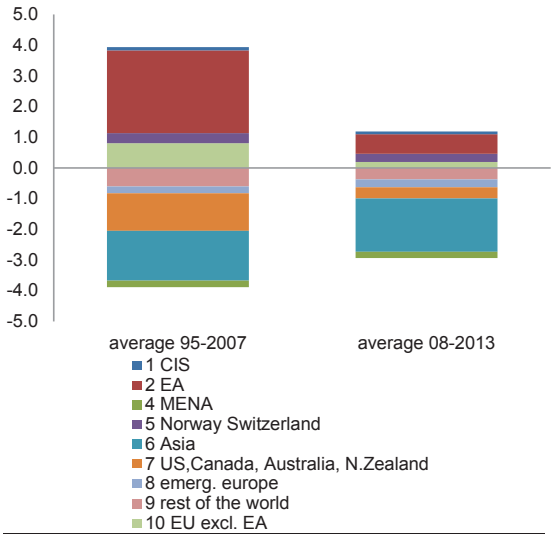
Graph 2.4.7: **Constant market share analysis**



Source: UN Comtrade, European Commission

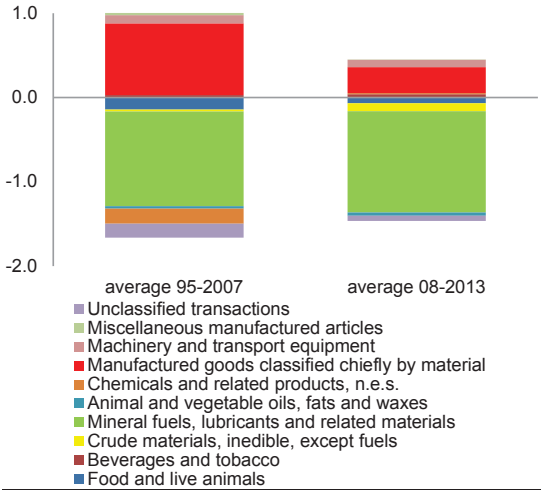
Austria's price competitiveness has been deteriorating since 2009 in relation to its euro area trading partners but has remained broadly stable overall. In the latter half of the 1990s, a depreciation in the real effective exchange rate (REER; using consumer prices as deflator) improved Austria's price competitiveness. Since then, the REER has fluctuated around a level below its long-term average. However, since 2009,

Graph 2.4.8: **Breakdown of geographical effect by main regions**



Source: UN Comtrade, European Commission

Graph 2.4.9: **Breakdown of the product effect by main sectors**

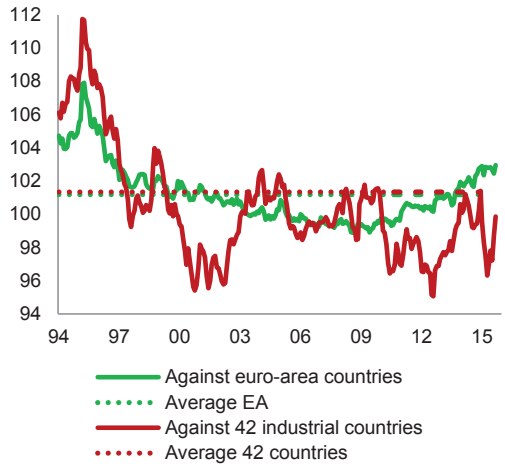


Source: UN Comtrade, European Commission

consumer price increases have been more pronounced in Austria than in its euro area trading partners. This suggests a deterioration in price competitiveness in relation to the euro area as a whole (Graph 2.4.10). One major driver of this development is the accelerated and comparatively high increase in unit labour costs. Between 2008 and 2014, wage increases were broadly in line with the euro area average, but productivity growth was negative (Graph 2.4.11). This may, for instance, partly explain why in recent years Austria has lost

ground to eastern European countries in the export of parts and goods to the German automotive sector. This development was not specific to Austria, however, as other automotive suppliers in western Europe have experienced similar or even greater losses in the German market. The real effective exchange rates either deflated by consumer prices or by unit labour costs qualitatively describe the same picture. Also, if export deflators are used to determine the real effective exchange rate, which then only indirectly considers the more domestic-oriented price impacts of administrative prices or the service sectors that have bolstered consumer prices in recent years, it shows that price competitiveness has remained broadly stable overall.

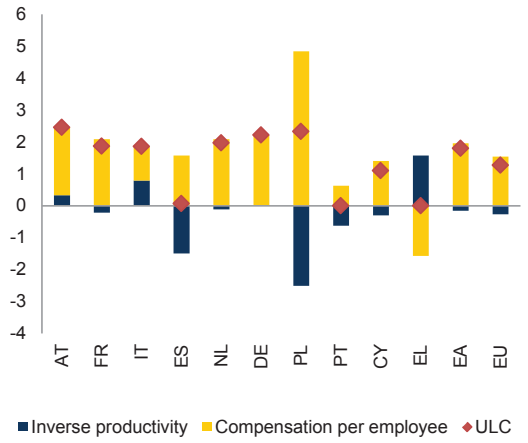
Graph 2.4.10: **Austria's real effective exchange rate (2005=100; deflated with consumer prices)**



Source: Eurostat

Austria might have experienced a moderate loss in non-price competitiveness in recent years. According to the *World Economic Forum's competitiveness indicator* ([18]), Austria suffered a moderate drop in competitiveness in a broad range of areas after a decade of broadly stable competitiveness. In 2015, Austria ranked 23 out of 140 countries (see table 2.4.1). In the latest report (2015-2016), the most problematic factors for doing business were identified as high tax rates, complex tax regulations and restrictive labour regulations. With regard to the flexibility of wage determination, Austria ranks 139 out of 140, and

Graph 2.4.11: **Unit labour cost (ULC), labour productivity and labour cost annual growth rate (%), 2008-2014**



Source: Eurostat

tax incentives to work have been ranked as similarly insufficient. The World Bank's *doing business* indicator, which ranks Austria 21 out of 189 countries, also highlights tax issues, but also procedures for starting a business. Overall, the World Bank's report does not suggest that there has been any increase in barriers to doing business in Austria in recent years. By contrast, focusing on Austria's competitiveness, the *IMD World Competitiveness Scoreboard* finds a continuous deterioration since the year 2010 from rank 14 (out of 58) to rank 26 in 2015 (out of 61).

([18]) Since 2004, the World Economic Forum's (WEF) competitiveness index comprises three sub-categories based on 12 pillars: basic requirements (institutions, infrastructure, macroeconomic environment, health and primary education); efficiency enhancers (higher education and training, goods market efficiency, labour market efficiency, financial market development, technological readiness, market size); innovation and sophistication factors (business sophistication, innovation). Previously, two different competitiveness indicators were constructed: growth competitiveness (structures, institutions and policies supporting economic growth over the medium term) and current or business competitiveness (company operations and strategy ranking, quality of the national business environment ranking). Owing to index revisions, a year-to-year comparison should be interpreted with caution.

Table 2.4.1: **World Economic Forum — Competitiveness ranking of Austria**

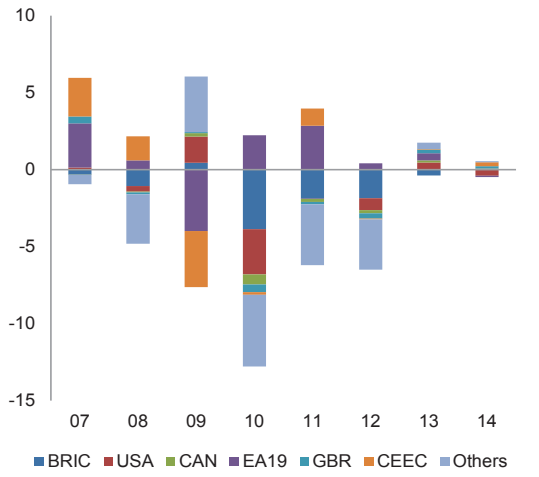
	Global Competitiveness (overall index)	Basic requirements [1]	Efficiency enhancers [2]	Innovation and sophisticated factors [3]	Countries considered
2015-2016	23	20	24	14	140
2014-2015	21	16	23	14	144
2013-2014	16	19	21	12	148
2010-2011	18	15	19	13	139
2008-2009	14	9	20	12	134
2006-2007	17	18	20	12	125
			Growth competitiveness	Business / Current competitiveness	Countries considered
2003-2004	-	-	17	17	102/101
2000	-	-	18	13	59/58

Source: World Economic Forum (2015 and previous issues), Cesifo DICE Report 3/2005 (database global competitiveness)
Note: Weight in overall index (2015 report): 1) 20 % 2) 50 % 3) 30 %

Austria's innovation performance appears to be sound overall but there is scope for improvement. The World Economic Forum indicates that Austria's innovative position is overall somewhat above the average for advanced economies. Furthermore, the European Commission's *Innovation Union Scoreboard 2015,* which defines Austria as an 'Innovation follower', finds that there has been an upward trend in Austria's innovation performance since 2007. However, the relative performance compared with its EU peers remained below pre-crises levels in 2014. In particular, a relatively poor performance in venture capital investments, patent revenues from abroad and exports of knowledge-intensive services stands out. (Further details on research and innovation in Austria can be found in chapter 3.5).

Other aspects also mitigate the concerns regarding Austria's loss of export market shares. Most of the market share loss is due to a sharp decline in market shares in 2010 and 2012, but the country has recovered some market share in recent years. The overall gain in market shares in 2013 and 2014 is related to increases in some eastern European countries (e.g. Hungary and Croatia) and Sweden. Moreover, the loss of market share in price-adjusted terms is much more limited than the indicator in value terms suggests (Graph 2.4.13). Additionally, alternative data sources and methods of calculating market share developments (e.g. unweighted vs weighted export/import growth) point towards an even lower magnitude of market share losses. Moreover, these market share losses have essentially been driven by losses in rapidly-growing markets overseas (such as China, Brazil, India and the US), while Austria's market share in CEE countries and euro area has remained largely unaffected (Graph 2.4.12).

Graph 2.4.12: **Contribution to the change in market share (pp.)**



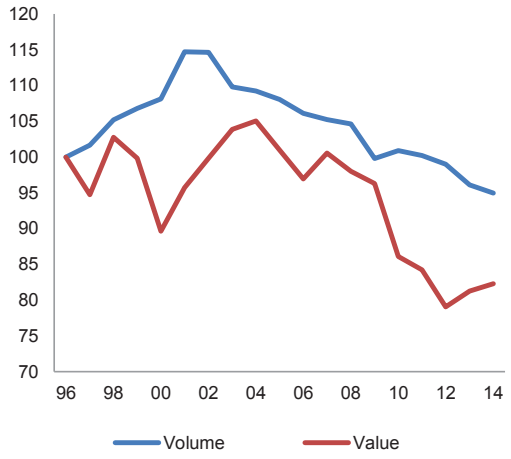
Source: Eurostat

Services and income balances

The surplus in the services balance has increased on the back of successful diversification. The surplus in the balance of services improved markedly until 2007 and has thereafter remained a significant contributor to the current account surplus. While tourism remained Austria's largest service export, other service sectors have gained a stronger footing, in particular business-related services, which increased significantly to become the second largest source of net services income (Graph 2.4.14). Even though there was an expansion in the trade in services with countries outside the EU (such as

Russia or China), the euro area still accounted for about three quarters of the services surplus (mostly from travel and business services).

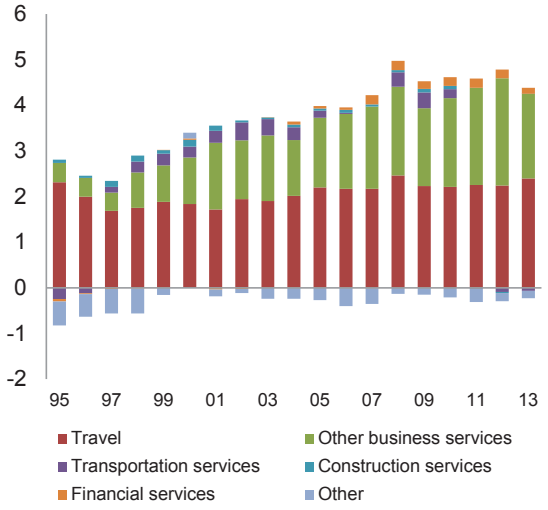
Graph 2.4.13: **Export market share of goods and services, in value and volume (index 1996=100)**



Source: AMECO, Eurostat, WTO, European Commission

The primary income balance has contributed to the rise in the current account surplus but turned negative in 2014. The balance of primary income continuously showed a negative balance until the mid-2000s and fluctuated around zero thereafter. Its dynamics can predominantly be explained by investment income, while labour income has become negligible and other primary income plays a small positive role. Since 2010, investment income has been on a moderate downward trend. It turned significantly negative in 2014 when a drop in the positive direct investment balance occurred, driven to a large extent by a reduction in net reinvested earnings. As a result, overall investment income turned negative in 2014 at almost -1 % of GDP. The drop in net direct investment income in 2014 needs to be interpreted with caution, given delays in the availability of actual income data which feeds into official statistics.

Graph 2.4.14: **Services balance (% of GDP)**



Source: Eurostat

The dynamics of the investment income balance are largely driven by direct investment income. Reinvested earnings have gradually been superseded by distributed profits with the onset of the financial crises. From 2002, there was a gradual turnaround in the balance of direct investment income, which peaked in 2008 at 1.5 % of GDP. This turnaround was solely driven by a surge in net reinvested earnings. Between 2002 and 2007, reinvested revenues from Austrian investments abroad increased much more dynamically than reinvested revenues from foreign investments in Austria. As of 2008, this changed significantly with the onset of the financial crises. Austrian investors abroad increasingly preferred to withdraw revenues and to pay out dividends instead of reinvesting them. This much more reticent attitude to reinvesting corporate earnings is a distinctive feature of the post-crisis period, bearing the signs of a preceding over-exposure or an adjustment in expected returns (including due to increased uncertainty, for example in the banking sector). Also in Austria, there has been a tendency since the crisis for foreign direct investors to withdraw a larger share of dividend payments and reinvest less, relatively.

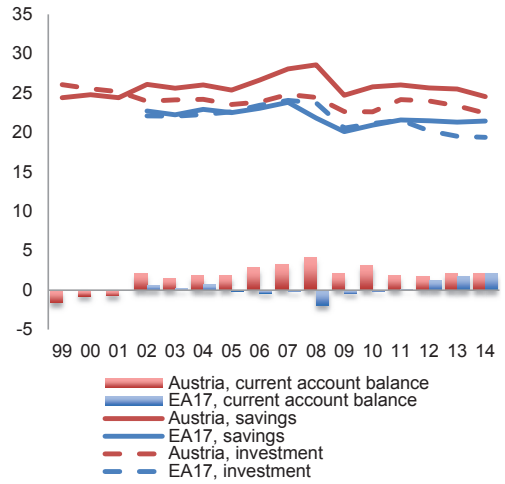
The savings-investment-perspective

The building up of the current account surplus until 2008 reflected growing savings from all sectors of the economy, most notably from non-financial corporations and the government. Austria's savings rate reached 28.6 % of GDP in 2008, close to seven pps. above the euro area average (Graph 2.4.15). This largely reflects the declining borrowing requirements of non-financial corporations, government sector consolidation in the run-up to the setting-up of the European Monetary Union, and an increase in households' savings (Graph 2.4.16).

A significant decline in households' savings accounts for most of the reduction of the current account surplus since 2008. During the crisis, Austrian households ran down their accumulated savings to maintain consumption growth at a relatively high level, despite lower growth in disposable income. Following the crisis, the government again started consolidating public finances. Non-financial corporations further reduced their borrowing requirements, running a surplus from 2010. While this essentially reflects a significant contraction of investment, which could hurt productivity and long-term growth, the balance sheets of non-financial corporations continued to steadily improve. This would indicate that there are no significant competitiveness issues.

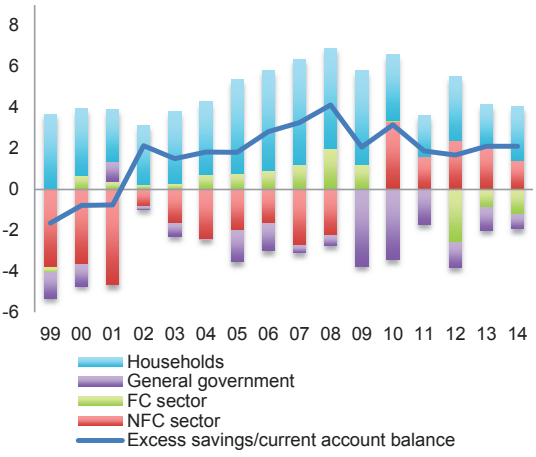
Looking ahead, the geographical market share risks remain unchanged since Austria's export market diversification has not changed substantially in recent years. At the same time, geographical opportunities remain unchanged as well, especially with regard to the ongoing recovery of economic activity in the euro area and the CEE region. The Commission Winter Forecast projects that Austria's export market growth will gain momentum. This should bolster export growth although Austria's real export performance is expected to remain subdued. Subdued export performance is based in part on the observation that Austria experienced some losses in price competitiveness in the currency union. Moreover, there seems to be scope for regaining and improving certain aspects of non-price competitiveness which could also help to meet the challenge of remaining in the European and global value chain.

Graph 2.4.15: **Current account balance, national saving and investment (% of GDP)**



Source: Eurostat

Graph 2.4.16: **Contribution to changes in Austria's current account balance (% of GDP)**



Source: Eurostat, European Commission

2.5. MIP ASSESSMENT MATRIX

This MIP Assessment Matrix summarises the main findings of the in-depth review in the country report. It focuses on imbalances and adjustment issues relevant for the MIP.

Table 2.5.1: **MIP Assessment matrix (*) — Austria**

	Gravity of the challenge	Evolution and prospects	Policy response
Potential imbalances			
Financial sector	The large foreign exposure of banks has strategic merits, but implies risks of inward spillovers via credit, currency and political risks. Although declining, the amount of assets of subsidiaries abroad is significant and a sizeable share of lending by Austrian banks and their subsidiaries is still denominated in foreign currency (Section 2.2.).	The deterioration in asset quality abroad implies declining profitability, but overall profits remain positive. Austrian banks have reduced their CESEE exposure since 2008 and their presence abroad is fairly diversified overall. Political and economic risks, notably as regards exposure to Ukraine and Russia, remain pronounced.	Supervisory action contributed to expanding the local funding base abroad and addressed deteriorating asset quality. The large stock of foreign currency loans in Austria and in several foreign countries has been addressed by supervisory action, yet deserve further monitoring.
	Austria's banking sector is resilient and supply factors play a limited role in subdued credit flows to firms. Still, the need to strengthen capital, low profitability and deteriorating loan portfolio quality for subsidiaries abroad are intertwined and could prevent the banking sector's lending capacity from keeping up with improved economic prospects. The ability to generate capital is hampered by low profitability in the domestic market and more volatile profits from international activities, notably due to increasing non-performing loans (Section 2.1.).	Capitalisation has gradually improved, but further strengthening is warranted. Rating downgrades for some Austrian banks have temporarily affected their funding and capital costs. Lending to the domestic corporate sector is impacted by low credit demand and to some extent also by increased risk aversion and regulatory requirements. Looking forward, tail risks to lending capacity remain, while surveys and the economic forecast point towards a recovery of investment.	Legislative action was taken to limit adverse spillovers of bank restructurings, although funding costs for Austrian banks temporarily rose. Overall, supervisory action has helped to gradually improve banks' capitalisation position. Macro-prudential measures are expected to further strengthen the risk-bearing capacity and resilience of the banking sector as a whole. Supervisory requirements have supported the reduction of bank funding needs over time.
	The restructuring and winding down of distressed financial institutions has continued to impact on public finances. Financial sector support has led to an increase in general government debt. Large amounts of impaired assets from financial defeasance structures are included in government accounts and	The restructuring of the banking sector has progressed continuously. Liquidity and capital support has increasingly been paid back by banks. Additional fiscal costs as well as legal issues related to wind-down vehicles may have a limited further impact on public finances. However, these	Wind-down vehicles for banks under restructuring have been put in place and followed up by legislative action. The 'bad bank' solution for Hypo Alpe Adria aims to limit the impact on public finances. A bank tax helped fund financial sector support measures. The

	represent an element of uncertainty for public finances, but risks of further costs are overall limited and relate to few specific institutions (Section 2.3.).	factors mainly relate to legacy issues for specific banks, while the overall restructuring of Austria's banking sector is advancing without the need for additional support from public finances.	implementation of the Bank Recovery and Resolution Directive (BRRD) considerably limits the risk of a further spillover on public finances.
External competitiveness	Since 2008, the Austrian economy has lost export market shares both in nominal and real terms, in particular due to geographical specialisation. Losses are to some extent also related to reduced price and non-price competitiveness, but in a longer time perspective the reduction appears to be limited (Section 2.4.).	Strong trade links with the euro area and the CEE region caused losses in export market shares since other markets grew more rapidly. Austria's market shares have recovered somewhat since 2013. Trade developments and indicators reflect limited competitiveness losses in recent years.	No significant policy measures have been taken that could be considered to have weakened the external competitiveness of the Austrian economy.

Conclusions from IDR analysis

- Austrian banks' exposure abroad and foreign currency loans implies that there is some potential for adverse spillovers, also in view of bank capital positions, profit prospects, and risks in Ukraine and Russia. The restructuring and winding-down of distressed financial institutions has continued to impact on public finances, yet risks of further costs are contained. Export market shares are being regained, but competitiveness trends should be monitored.

- The banking sector's foreign exposures have reduced and the geographical presence abroad is overall diversified and remains a principal source of profits. Feedbacks from banks' balance sheet adjustments on other sectors have been contained. Improved capitalisation and de-risking is expected to gradually support the banking sector's lending capacity. Legacy issues, notably the divestment of impaired banking assets and legal uncertainties, may have a limited further impact on public finances. However, banking sector restructuring is advancing without the need for additional public support. BRRD requirements help insulating public finances from further costs.

- Supervisory measures helped to improve the local funding base and asset quality of operations abroad. Other prudential measures strengthened the risk-bearing capacity and resilience of the domestic banking sector. Public support in line with State aid rules enabled viable banks to overcome market turbulences and ensured the wind-down of other banks, while preserving financial stability. The bank tax contributed to finance the support.

(*) The first column summarises 'gravity' issues which aim at providing an order of magnitude of the level of imbalances. The second column reports findings concerning the 'evolution and prospects' of imbalances. The third column reports recent and planned relevant measures. Findings are reported for each source of imbalance and adjustment issue. The final three paragraphs of the matrix summarise the overall challenges, in terms of their gravity, developments and prospects, policy response.

3. ADDITIONAL STRUCTURAL ISSUES

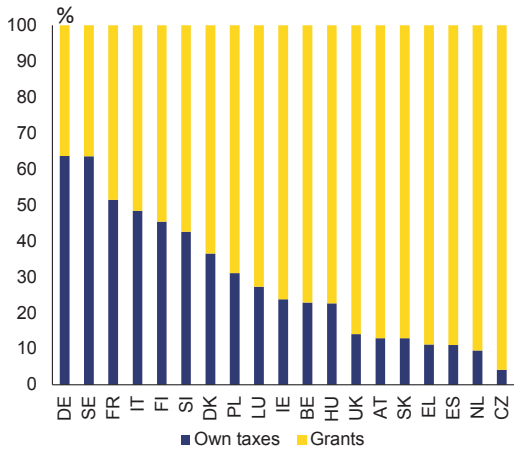
In addition to the analysis of possible macroeconomic imbalances in section 2, this section provides an analysis of other structural economic and social challenges for Austria. Focusing on the policy areas covered in the 2015 country-specific recommendations, this section first analyses issues related to the economic efficiency of fiscal relations between different levels of government before looking at the effects of the 2016 tax reform in the second part. Third, the labour market and social policies are examined, focusing on labour participation, overall equality and long-term sustainability of the social security system. In the fourth part, the challenges for the Austrian education system and those arising from the increased inflow of refugees and migrants are analysed. The fifth and final part concentrates on promoting long-term growth by identifying barriers to doing business in the services sector, also focusing on the financing situation for small- and medium-sized businesses and business start-ups.

3.1. FISCAL FRAMEWORK

Streamlining fiscal relations between different levels of government is a longstanding challenge in Austria. The institutional setting of fiscal relations between the central government, federal states and municipalities dates back to the Fiscal Constitutional Law of 1948. Since then, the legal framework for fiscal relations has constantly grown in complexity in order to achieve consensus between the different stakeholders. For many years, in light of the economic efficiency losses entailed, the Austrian authorities have recognised the need for a comprehensive reform. Nevertheless, opposing interests embedded in the current institutional setting have made previous reform attempts difficult. The Fiscal Equalisation Law (*Finanzausgleichsgesetz* – FAG), allocating revenues between the three levels of governments, is negotiated every six years. The current agreement expires at end of 2016. Since mid-2015, working groups have been set up to draw up proposals for reforms, to be discussed by the National Parliament and implemented from 2017.

The current system entails a misalignment between funding and spending responsibilities. On the one hand, the degree of fiscal decentralisation is relatively high in terms of the share of sub-national government outlays in total general government spending (30.6 % of general government spending in 2014, or 16 % of GDP – OECD data). This reflects the fact that sub-national governments have spending responsibilities in major sectors, such as social assistance, healthcare (hospitals), parts of primary and secondary education, kindergartens, and the functioning of local and regional infrastructure. On the other hand, fiscal decentralisation appears low when it comes to revenues. Most sub-national revenue is provided by the federal government in the form of tax-sharing and intergovernmental transfers (Graph 3.1.1) and the amount of revenue stemming from sub-national governments' own taxes ([19]) is comparatively low (Graph 3.1.2).

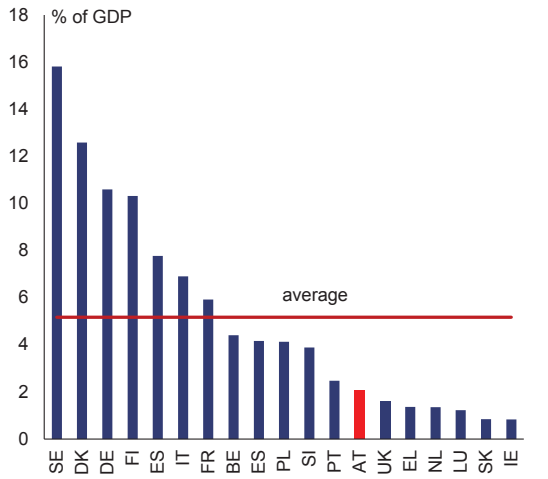
Graph 3.1.1: **Sources of sub-national revenues in 2013**



Source: OECD, European Commission

([19]) Sub-national own taxes are defined as taxes which subnational governments have the power to introduce, or alternatively modify the tax rate and/or the tax base.

Graph 3.1.2: **Sub-national own taxes in 2014**



Source: OECD

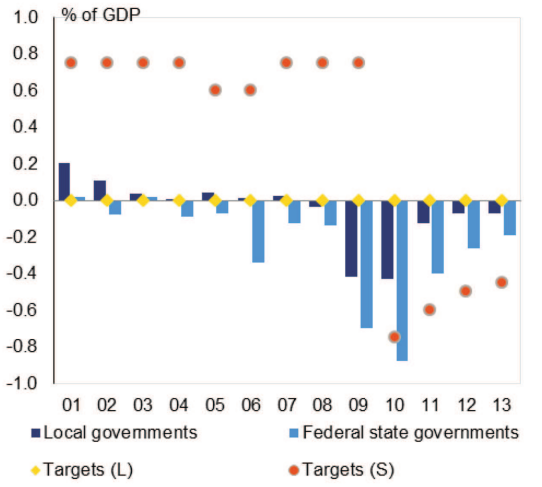
Setting revenue-raising powers and spending responsibilities at different levels of government is not cost-effective. The mismatch does not incentivise sub-national governments to reduce expenditure, given the asymmetric relationship with taxpayers. On the expenditure side, taxpayers perceive federal states and municipalities as providers of numerous services, while for the revenues they consider the federal government to be the main taxing agent. As a consequence, fiscal accountability is shifted to the federal level, resulting in reduced pressure on sub-national governments. Allowing sub-national governments to raise more own revenue, primarily through local taxation, is generally seen as a way of promoting fiscal discipline ([20]). Other studies show that transfer dependency is often linked with larger fiscal deficits, especially if associated with high expenditure decentralisation ([21]).

([20]) Oates, W.E. (2006), 'On the Theory and Practice of Fiscal Decentralization', IFIR Working Paper No 2006-05; IMF (2009), 'Macro Policy Lessons for a Sound Design of Fiscal Decentralization'; Blöchliger, H. and Petzold, O. (2009), 'Finding the Dividing Line Between Tax Sharing and Grants: A Statistical Investigation', OECD Working Papers on Fiscal Federalism, No 10.

([21]) Rodden, J. and Wibbels, E. (2009), 'Fiscal decentralization and the business cycle', Economics & Politics, No 22/01.

Local governments have a higher share of autonomous taxes than federal state governments, which traditionally has been reflected in better fiscal performance of the former. The share of own taxes over total revenue is twice as high for municipalities as it is for federal states (17.7 % versus 8.5 % -OECD data for 2013). This has coincided with a more contained evolution in expenditure and better overall compliance with budgetary targets on the part of local governments. Federal state governments consistently failed to meet their budgetary targets from 2001 to 2010. By contrast, local governments showed better compliance, exceeding their targets in most years in the period before the economic crisis (Graph 3.1.3). Overall, higher tax autonomy seems to have encouraged municipalities to contain expenditure while allowing flexibility in addressing adverse economic conditions.

Graph 3.1.3: **Sub-national governments headline balance**

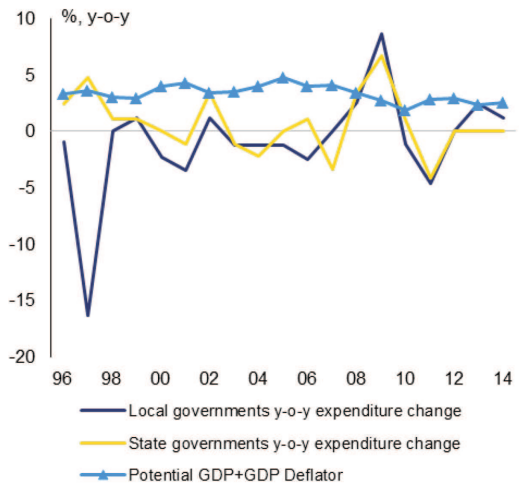


Source: OECD, European Commission

The reform of the Austrian Internal Stability Pact, which entered into force in 2012, has strengthened Austria's fiscal framework. The reform set new and - from 2017 - permanent deficit ceilings at the level of the central government, federal states and municipalities (collectively by federal state) in order to enhance general fiscal discipline. As at the European level, budgetary targets are set both in nominal and structural terms, even at sub-national level. The adoption of an expenditure benchmark seems to have played a role in containing general

expenditure of sub-national governments, especially for federal states, as suggested by the comparison with the national Austrian benchmark (Graph 3.1.4). As for the nominal budget balance, federal states appear to have mostly met their targets in recent years, while they were constantly missing them before the crisis (Graph 3.1.3). Although complying with current targets is meant to bring their budgets to a balanced position by 2016, it should be considered that improved compliance is helped by the fact that current nominal targets are far less ambitious than in the pre-crisis period.

Graph 3.1.4: **Sub-national government expenditure**



Source: OECD, European Commission

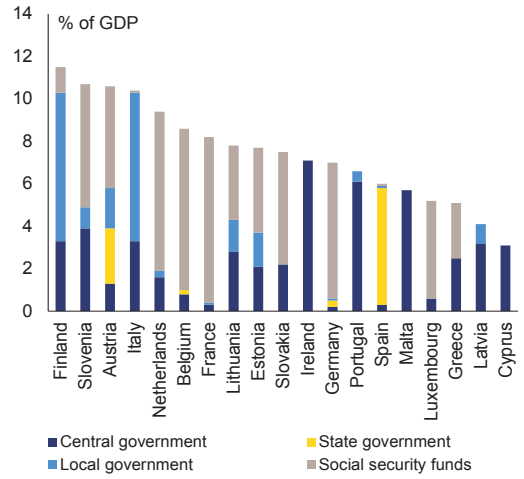
However, the complexity and lack of transparency of the system make effective monitoring difficult. According to the agreed EU framework (the 'Two-Pack', Regulation No 473/2013), each euro area Member State should have in place an independent body to monitor compliance with country-specific fiscal rules. In November 2013, Austria nominated the Fiscal Council (previously the 'Public Debt Committee') as the body responsible. The Council has since issued two reports on compliance with fiscal rules in Austria (in May 2014 and May 2015). However, these reports only pronounced verdict as to what extent Austria respected EU fiscal rules and were not able to assess compliance with its own, country-specific rules. According to the Fiscal Council ([22]), the reason it was not able to assess compliance with the national fiscal rules, and in particular with national expenditure rules, is that no ESA 2010 (European system of accounts) data are available on expenditure at the level of individual federal states and municipalities (collectively by federal state). This is explained by the complex flows of transfers between the units of various levels of government, and the large number of units and institutional arrangements, which vary widely between federal states. The Fiscal Council also points out the difficulty of calculating potential output (which must be used in planning expenditure in line with the rules) at federal state level. At the end of 2015 a new and harmonised system of accounting rules for federal state governments and local governments was approved, and will come into effect in 2019-2020. The reform is intended to improve the transparency of fiscal relations and allow for a better coordination and comparability of budgets at all levels of government. However, it is unclear to what extent the reform would also allow for a better monitoring of compliance with the national rules.

The high fragmentation of competencies entails efficiency losses in crucial sectors of spending, such as healthcare. Despite caps on overall spending, the organisational structure of specific sectors of activity remains inefficient and prevents stakeholders from reducing unnecessary costs. One example is healthcare, one of the main drivers of expenditure at local and federal state level. Austria has the third highest public expenditure on healthcare (as a proportion of GDP) and is the only Member State in the euro area where this sector involves four different government entities (Graph 3.1.5). One major reason for the high spending is the degree of hospitalisation, considerably higher than the OECD average, which is in turn linked to the distribution of competencies between government levels. Federal states and local governments are both involved in providing hospital services, while out-patient care is provided by social security services. Since different stakeholders are responsible for the in-patient and out-patient services, there are weak

([22]) Austrian Fiscal Advisory Council (2015), 'Bericht über die Einhaltung der Fiskalregeln 2014–2019' and Austrian Fiscal Advisory Council (2015), 'Umsetzung des Korrekturmechanismus zur Einhaltung des mittelfristigen Budgetziels in Österreich'.

incentives to move workload from costly hospitals to general practitioners, whose services are cheaper. In fact, such a move would shift managing responsibility and political influence away from sub-national governments, while increasing costs for social security services. According to the federal audit court, shifting part of hospital services to general practitioners would generate savings of just under 1 % of GDP ([23]).

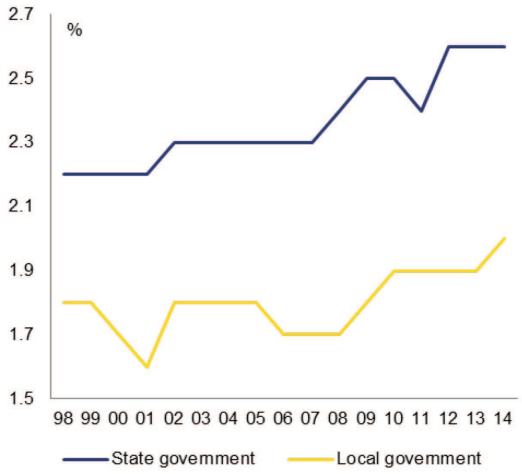
Graph 3.1.5: **Health expenditure by government level in 2013**



Source: Eurostat

With the reform of the Austrian Internal Stability Pact, agreement was reached to limit health expenditure growth. In the context of the health system reform plan (2013-2016) the different layers of government agreed to limit public health expenditure growth from 2016 onwards so that it remains in line with expected average nominal GDP growth. It is promising that federal states' healthcare expenditure, having for many years exhibited a rate of growth above that of other levels of government and above nominal GDP growth, has been much better controlled in recent years (Graph 3.1.6). According to the monitoring report ([24]), federal states reached their financial targets for 2013, 2014 and 2015. Nevertheless, given that the estimated average nominal GDP growth of 3.6 % proved to be optimistic compared with the growth observed since 2013, it may be that lower expenditure caps will have to be set (see also section 3.3.). As a consequence, compliance may turn out to be more difficult in the future, not least against the background of the full effects of an ageing population.

Graph 3.1.6: **Sub-national governments – health expenditure growth**



Source: Eurostat

([23]) Austrian Court of Audit (2011), 'Verwaltungsreform 2011'.

([24]) Federal Ministry of Health (2015), 'Zielsteuerung-Gesundheit - Monitoringbericht I/2015'.

3.2. TAXATION

In July 2015, Austria enacted a comprehensive reform of the country's tax system. The reform expands the progressive income tax scale for individuals to six brackets, ranging from an initial 25 % rate to a ceiling rate of 55 %. Other aspects of the reform include an increase of the annual tax-exempt allowance for children, a reduction in the minimum monthly contribution for health insurance for self-employed workers, an increase in tax credits for employees, and the reimbursement of social security contributions for those with a very low tax liability. The reform took effect in January 2016, with an annual tax relief estimated by the Austrian government at around EUR 5 billion. Several types of compensatory measures have been adopted, which mainly include a restriction of bank secrecy accompanied by the adoption of compulsory cash registers to combat tax fraud, together with spending cuts in administration, grants and subsidies. Minor yields are expected from an increase of the withholding tax on capital gains to 27.5 %, an increase of the reduced VAT rate from 10 % to 13 % for certain goods and services, and increases in other taxes. However, uncertainty remains as to whether the financing measures will be sufficient to cover the full tax relief.

The tax wedge on labour will be considerably reduced, with positive effects on consumption and incentives to work. Tax brackets have been adjusted, in particular by reducing the entry rate for personal income tax from 36.5 % to 25 %. Under the new system, income is divided into seven different income classes ([25]). EUR 300 million of additional expenditure is envisaged to support family policy and research activities. These measures are likely to support disposable income, and to increase incentives to work for individuals with low earning potential, even if a stronger focus on lower income earners would have produced higher work incentive effects (see Box 3.1.1). Overall, the 2016 tax reform helps reduce disincentives to employment creation and contributes to a better climate for investment in human capital, in line with the recommendations of the Annual Growth Survey 2016.

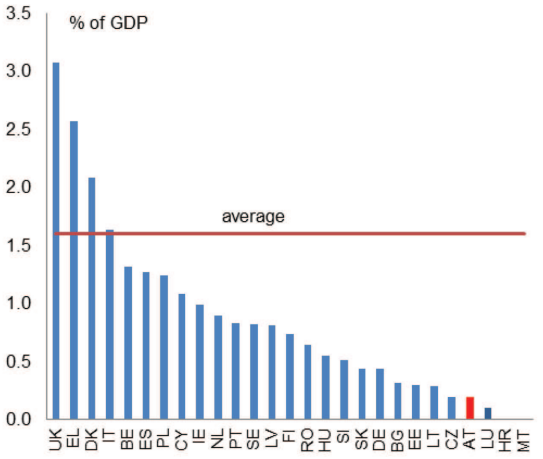
Although the tax relief on labour income is welcomed, the tax reform does little to shift the tax burden to other sources of taxation less detrimental to growth, notably recurrent taxation on housing and environmental taxes. The reform introduced some changes in the field of property taxation, in particular the unit value of the tax on gratuitous property transfers was increased and three tax brackets (0.5 %, 2 % and 3.5 %) were introduced for the same tax instead of the previous flat rate of 2 %. Also, capital gains related to transfers of immovable property were increased from 25 to 30 %. Nevertheless, the reform did not affect recurrent property taxation, despite it is considered to be among the most growth-friendly taxes. Compared with other Member States, Austria has room to increase this form of taxation, with revenues from taxes on recurrent property substantially below the EU average in 2012 (0.2 % of GDP versus 1.5 % of GDP; Graph 3.2.1) ([26]). Similarly, Austria did not use the opportunity of the tax reform to overhaul its environmental taxes in order to achieve environmental targets. Slight changes favouring cars with low CO_2-emissions ([27]) were the only environment-related measure.

([25]) The rates, based on income per annum, are as follows:
- 0 to EUR 11 000: tax free
- EUR 11 000 to EUR 18 000: 25 %
- EUR 18 000 to EUR 31 000: 35 %
- EUR 31 000 to EUR 60 000: 42 %
- EUR 60 000 to EUR 90 000: 48 %
- EUR 90 000 to EUR 1 million: 50 %
- Over EUR 1 million: 55 % (rate applicable from 2016-2020, then subject to review).

([26]) Revenues from charges for the use of municipal establishments and facilities (Gebühren für die Benützung von Gemeindeeinrichtungen und –anlagen) accounted for EUR 22 578 million in 2013 which is about 0.7 % of GDP. 95 % of these revenues are to be attributed to water supply and sewerage and waste disposal, at least in all municipalities except Vienna - see Statistik Austria (2014), 'Gebarungsübersichten 2013'.

([27]) The taxable income from the private use of company cars was increased from 1.5 % to 2 % of the total acquisition cost of the car, and the right to deduct tax for CO_2-emission-free cars was introduced.

Graph 3.2.1: **Revenue from recurrent property taxation on housing in Austria compared with other Member States, 2014**



Source: Eurostat

Austria appears to have a potential scope to increase environmental taxes ([28]). Although revenues from environmental taxes are in line with the EU average (2.46 % of GDP for Austria and for the EU-28 average in 2014 – Eurostat data) the potential to shift tax burden away from labour still exists, as the implicit tax rate on energy is relatively low compared with the EU level (183.3 EUR per tonnes of oil equivalent for Austria and 222.8 for the EU).

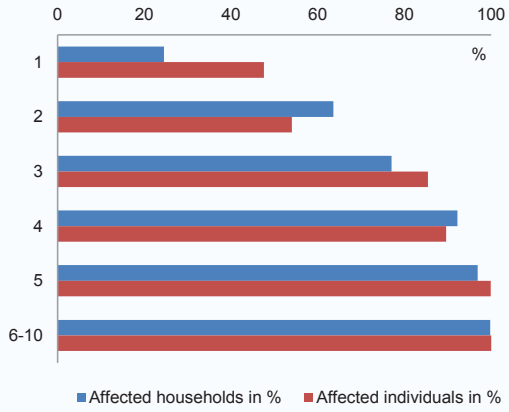
Recent data ([29]) show that Austria offers tax advantages on company cars that encourage the excessive use of fossil fuels and undermine energy, climate and environmental objectives. The preferential tax treatment for company cars leads to estimated revenue losses of EUR 558 million (0.42 % of total tax revenues) in Austria, and ranges from e.g. EUR 1 043 million for Germany to EUR 53.4 million for Portugal (0.49 % and 0.1 % of total tax revenues respectively). Additional revenues from less preferential tax treatment for company cars stemming from the recent tax reform are estimated to amount to just EUR 50 000 per year. The current falling fuel prices provide an opportunity to reform the level of energy taxation.

([28]) European Commission (2015), 'Tax Reforms in EU Member States 2015', Institutional Paper 008.

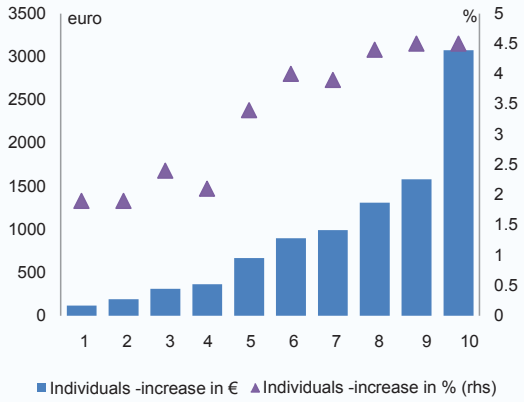
([29]) European Commission based on Harding, M. (2014), 'Personal Tax Treatment of Company Cars and Commuting Expenses: Estimating the Fiscal and Environmental Costs', OECD Taxation Working Papers, No 20.

Box 3.2.1: Euromod simulation on the distributional and budgetary effects of the tax reform

Graph. 1: **Individuals and households affected by the tax reform by income decile groups**



Graph. 2: **Increase in yearly disposable income after the reform by income decile groups /Individual income earners**



The EUROMOD microsimulation model ([1]) was applied to analyse the distributional and budgetary effects of the 2016 tax reform in Austria. The model applied the majority of tax relief elements ([2]). According to the simulation, the overall size of the tax relief is considerable, amounting to EUR 5.42 billion when the measures and implementation schedule indicated in the 2015 National Reform Programme are taken into account.

As for the distributional effects of the reform, the EUROMOD simulation shows that the effect of the tax relief is unevenly distributed. Comparing individual disposable income for employees and self-employed workers across decile groups before and after the reform, the reform appears to affect only half of the income earners at the lower end of the earning distribution (Graph 1), while the proportion of affected individuals increases with earnings (100 % are affected starting from the 5th decile upward). Furthermore, the gains in disposable income increase in proportion with pre-reform income, both in relative and absolute terms (Graph 2). For the bottom 10 % earners, disposable income increases by 1.9 % on average (EUR 119), while for the top 10 % earners it increases by about 4.5 % (EUR 3 077). Also looking at equivalised household income, the effect of the tax relief appears to be distributed asymmetrically. The reform affects less than a quarter of households in the first decile group (Graph 1), while their disposable income increases by less than half a per cent (Graph 3). In the top decile group, almost all households are affected and the average increase in disposable income is about 4.4 %. Overall, the upper half of the income distribution benefits from almost 80 % of the tax relief (Graph 4). Naturally, high-income earners benefit more from the tax relief because of the cumulative reduction in tax liability, given that they are affected by the reform of a higher number of tax brackets. Nevertheless, the impact of the tax relief in the bottom income decile groups appears particularly low, both in terms of the proportion of individuals affected and in terms of the increase in disposable income. This is partly owed to the fact that incomes below the basic tax-free allowance (EUR 11 000) are not affected by the reform.

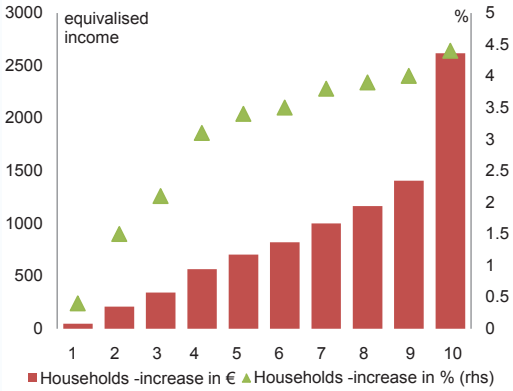
([1]) European Commission, Joint Research Centre, based on the EUROMOD model

([2]) The findings in box 3.2.1 relate exclusively to the tax relief element of the reform, excluding what is called in the 2015 National Reform Programme the 'location package', which is not simulated. The simulation also contains limitations concerning the traffic tax credit. The financing side of the tax reform is not presented in the box, since underlying data and modelling restrictions allowed simulating only one financing measure, i.e. the tightening of conditions for the 'exceptional expenses allowance' (before the reform, a variety of special expenses was deductible within certain limits from the personal income tax, with a standard lump-sum deduction of EUR 60 per year in case higher special expenses could not be proven; as of 2016, several specific deductions are abolished.). When considering this financing measure, the overall revenue loss caused by the reform is brought down to EUR 5.37 billion.

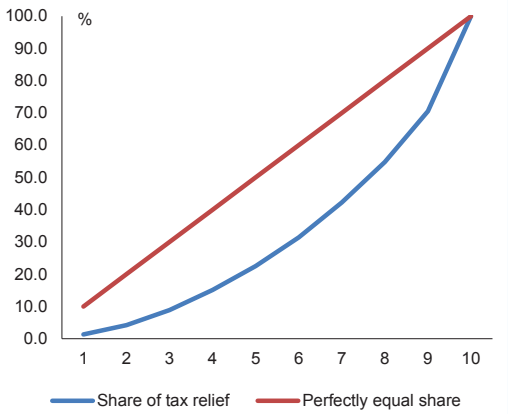
(Continued on the next page)

Box (continued)

Graph. 3: **Increase in yearly disposable income after the reform per income deciles /Equivalised household income**



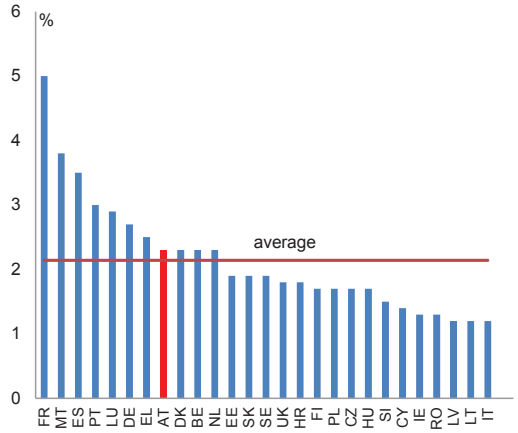
Graph. 4: **Cumulative share of the tax relief per income deciles**



Nevertheless, financing measures are likely to balance the asymmetric distribution of the tax relief. Several financing measures will affect mainly higher income earners, such as the uniform depreciation rate for buildings used as business assets and the 'solidarity package' (increase in the real estate transfer tax, real estate capital gains tax and investment/income capital gains tax). These and similar financing measures which cannot be currently considered in EUROMOD could lead to a less regressive distributional effect. It should be noted that, in a comparable study, the Austrian Institute of Economic Research (WIFO) projects a slightly less asymmetric distribution of tax relief than the EUROMOD simulations produced by the Joint Research Centre.

Overall, the 2016 tax reform contributes to considerably reducing the tax wedge on labour in Austria, moving in the direction of the Commission recommendations and the Annual Growth Survey 2016. Nevertheless, a stronger focus on lower income earners would have produced higher work incentive effects. Similarly, shifting the relief towards low-income households would probably have produced more significant effects on consumption, given the stronger propensity to save for higher income households.

Graph 3.2.2: **Difference between the effective marginal tax rates for new equity and for debt in %**



Source: ZEW (2014)

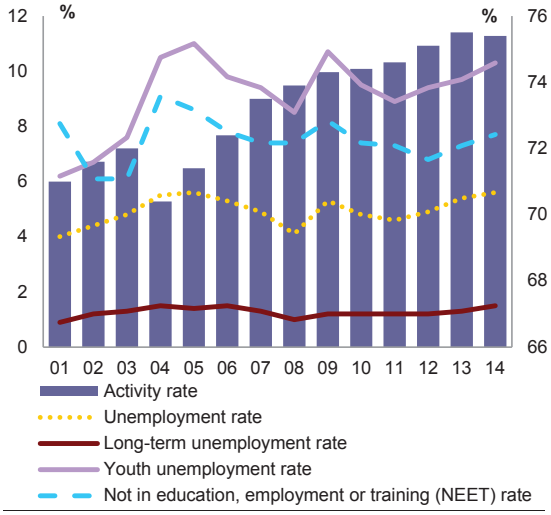
Austria features a debt bias in corporate taxation. Interest payments are generally deductible from taxable income. The debt bias in Austria is relatively high. In fact, Austria is ranked eighth out of EU-28 with respect to the gap between the post- and pre-tax cost of capital for new equity and debt-funded investments (Graph 3.2.2). Yet, data on indebtedness do not point to this having resulted in an excessive level of private debt (see section 2.1.).

3.3. LABOUR MARKET AND SOCIAL POLICIES

Labour market

After performing well during the crisis, the labour market situation has recently been deteriorating. Weak GDP growth has since 2011 led to deteriorating job-finding rates, while labour supply is increasing. For several months in 2015 the unemployment rate reached 6.0 %, up from 4.2 % in the third quarter of 2011, while the employment rate for the third quarter 2015 reached 75.0 %. Employment continues to increase, with 44 800 part-time and 16 500 more full-time jobs in the third quarter of 2015. Wages adapted, albeit slowly, with more moderate increases in line with the weaker domestic economy. After two slightly better years, the risk of poverty or social exclusion returned to the 2011 level (19.2 % in 2014, below the EU-28 average of 24.4 %). The long-term unemployed are the group at highest risk of poverty in Austria, which reflects a relatively low level of benefits.

Graph 3.3.1: **Labour market situation in Austria**



Source: Eurostat

While tackling the increase in unemployment is an immediate challenge, making better use of labour potential is crucial in the medium term. The relatively low labour market participation rates of older workers, women, low-skilled people and workers with a migrant background could erode Austria's growth potential.

Table 3.3.1: **Labour market outcomes of specific groups, 2014**

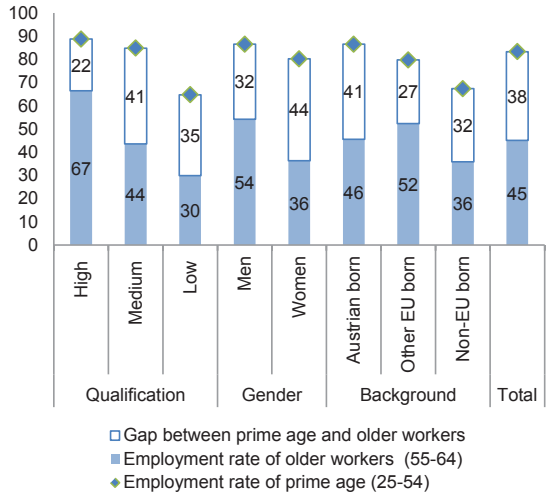
	Employment rate	Unemployment rate	Proportion of population (20-64)
Austrian born (20-64)	76.2	4.5	79%
Older workers (55-64)	45.1	3.8	20%
Women (20-64)	70.1	5.4	50%
Non-EU born (20-64)	61.2	12	12%
Austria total (20-64)	74.2	5.6	100%

Source: Eurostat, Labour Force Survey and population statistics

Austria has one of the lowest activity rates for older workers in the EU. Only 48.2 % of people aged between 55 and 64 years were on the labour market in the first three quarters of 2015, while the EU-28 average was 57.0 %. The employment rate of older workers (55-64) is also comparatively low (46.0 % for the first three quarters of 2015 compared with the EU average of 53.0 %), even though it represents a considerable increase from 27.4 % in 2001. Among older workers, the employment rate of women (38.6 % in the first three quarters of 2015) remains much lower than that of men (53.7 %). Comparing prime-age and older workers, the decline in the employment rate is particularly pronounced for medium-skilled and older female workers, at over 40 pps. (table 3.3.1).

As a general rule, workers aged 50 and more tend to be in more stable types of employment, but once they are out of work it is very difficult for them to return. The unemployment rate for the age group 55-64, according to the definition used by Eurostat, was 4.5 % in the third quarter 2015, 1.1 pp. above the value for the third quarter 2014. The vulnerability of this group is also reflected in the relatively high figures for long-term unemployment and the longer average duration of unemployment (132 days for 50+, compared with a general average of 104 days, and 72 days for people under the age of 25).

Graph 3.3.2: **Employment rate of older and prime age workers, 2014**



Source: Eurostat, Labour Force Survey

The business environment is not always adapted to the employment of older workers. Companies value their existing older workers, but they are often cautious about taking on new ones. On average, 12.1 % of Austrian workers and employees in companies with over 25 staff are aged 55 or over. This share varies significantly between sectors: from 3.9 % in veterinary services and 4.0 % in telecoms, to 22.9 % in ore mining and 24.3 % in waste disposal ([30]).

Austria is encouraging people to remain longer in work. From 2014 early retirement access and temporary invalidity allowances for people under the age of 50 have been restricted and replaced by the 'rehabilitation benefit' (*Rehabilitationsgeld*) and the 're-training benefit' (*Umschulungsgeld*). The government also reduced access to long-term insurance period pensions (*Hacklerregelung*) by increasing the entry age from 60 to 62 for men and from 55 to 57 for women starting from 2014 and imposing an annual deduction of 4.2 % for early retirement. As a result, the effective retirement age is increasing. The new partial retirement scheme (*Teilzeit-Pension*) makes it possible to remain in part-time work while receiving a part of a pension. A premium, financed by the state, allows employees to reduce working time by 50 % while receiving 75 % of their salary.

The current government has committed itself to specific employment targets for older workers and intensified its active labour market policy for this group. By 2018, Austria aims to reach an employment rate of 74.6 % for men aged 55-59 years, 62.9 % for women aged 55-59 years and 35.3 % for men aged 60-64 years. To achieve those targets, the Austria 50+ employment initiative was set up, with a total budget of EUR 220 million per year in 2014 and 2015. The funds will be increased to EUR 250 million per year for 2016 and 2017. Each year around 20 000 people are expected to benefit from the initiative, leading to more than 8 000 permanent jobs. The Fit2Work counselling infrastructure, which supports employees and employers in health maintenance, has been rolled out in all regions. As of 2018 a system of bonuses and penalties is planned to be introduced. Employers' contributions to the 'family burdens equalisation fund' (FLAF) will be reduced by 0.1 pp. if they employ more older (55+) workers than the sector average. Employing fewer will trigger a penalty equal to twice the job contract dissolution fee (Auflösungsabgabe).

Women's labour market potential remains underutilised. While the employment rate of women is above the EU-28 average (70.1 % vs 64.1 % for the age group 20-64 in the first three quarters of 2015), taking into account full-time equivalents brings it back to average levels. This reflects the fact that the rise in the employment rate of women has almost exclusively been a result of the expansion of part-time work. In 2014, as many as 73.5 % of Austrian women with children under 15 years of age worked part-time, compared with 39.1 % in 1994. Among men, working part-time has been marginal.

The high share of women working part-time (47.38 % for the first three quarters of 2015) is largely driven by care responsibilities. More than half of women aged 15-39, and just under 40 % of all women who worked part-time, cited looking after children or incapacitated adults as a reason. Men are considerably less involved in care responsibilities. The number of early childcare places for children up to the age of two has been doubled in the five years to 2012/13, but the

([30]) Bundesministerium für Arbeit, Soziales und Konsumentenschutz (2015), 'Beschäftigungs-, Rehabilitations- und Pensionsmonitoring auf Basis der Daten Jänner bis Juni 2015.'

current level of 23.8 % in 2014/2015 is still below the Barcelona target for this group (33 %). Furthermore, the provision of childcare compatible with full-time employment is not yet sufficient. Women are still interrupting their professional career for a relatively long period after giving birth, supported by the relatively generous system of parental leave allowances. Most older dependents are cared for in their or their family's home by family members, the vast majority of whom are working-age women. Despite some progress, the provision of quality childcare, all day schools and long-term care facilities compatible with full-time employment remains inadequate.

A sizeable low-wage trap for second earners (42.5 % vs 33.4 % in the EU in 2014), is a further incentive for remaining in part-time employment ([31]). The marginal tax rate in the first tax bracket is rather high and causes a considerable disincentive to extend working hours for employees whose income is close to but below the respective annual gross earnings threshold. Many women are concentrated in this part of the earnings distribution. Additionally, the income tax system includes a 'sole earner deduction' for families where the annual taxable income of the second earner does not exceed EUR 6 000. This discourages marginally employed second earners from working more than about 10 hours weekly for the average wage. The income tax reform taking effect from 2016 on does not improve this situation (see also section 3.2. Box 1).

The gender pay gap remains very high (23 % in 2013, compared with an EU average of 16.3 %) and this has not changed substantially in recent years (2006: 25.5 %). Only around one third of the gender pay gap can be explained by structural factors such as sectorial and occupational segregation of the labour market ([32]). The government programme adopted in 2013 includes a number of measures which aim to reduce the gender pay gap between men and women. These comprise obligatory equal pay reports by companies, a legal requirement to state the minimum wage in job vacancy advertisements and a number of other measures, such as a wage calculator and awareness-raising for unconventional career paths (e.g. girls' days/boys' days).

People with a migrant background make up an increasing share of the Austrian population, but their labour market potential remains seriously underutilised. The number of people with a migrant background ([33]) increased from 1.4 million in 2008 to 1.7 million in 2014. While the employment rate of people born in other EU countries is somewhat lower than that of Austrians (73.9 % versus 76.2 % for 20-64 year old), there are more significant gaps with the employment rates of non-EU born citizens, especially women. Employment outcomes are somewhat better for the second generation (children born to parents of whom at least one was born outside the EU) than for the first generation, but generally integration difficulties persist in case of Austrian-born whose both parents were born outside the EU (62.2%) (Graph 3.3.3) ([34]).

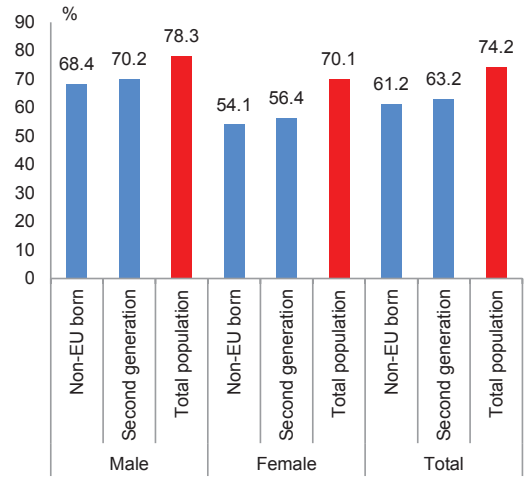
([31]) The low-wage trap shows the share of a family's additional earnings arising from an increase in work productivity which are wiped out by increasing taxes and benefit withdrawal. The family considered here has two-earners with two children, where the principal earner earns the average wage and the second earner increases its gross wage from 33 % of the average wage to 67 %.

([32]) Geisberger, T. and Glaser, T. (2014), 'Geschlechtsspezifische Verdienstunterschiede — Analysen zum Gender Pay Gap auf Basis der Verdienststrukturerhebung 2010', Statistische Nachrichten 2014, No 3, Statistik Austria.

([33]) This includes first generation migrants (who immigrated themselves) and second generation (whose parents immigrated). In Austria, about 75 % of people with a migrant background are first generation migrants, and 25 % second generation. (Statistik Austria).

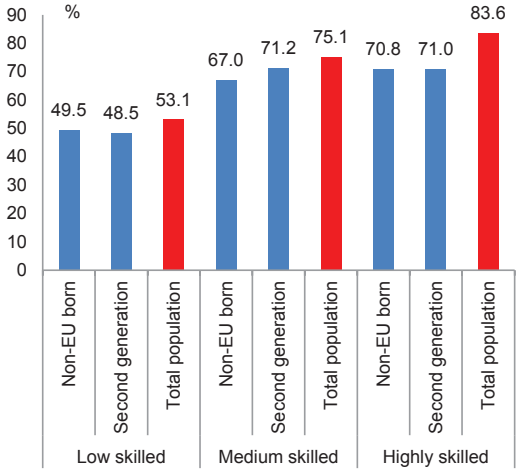
([34]) Also, there are more people categorised as 'NEET' (Not in Education, Employment, or Training) among second generation migrants than among first generation of migrants — see section 3.4.

Graph 3.3.3: **Employment rates by background and gender, 20-64, 2014**



Source: Eurostat, Labour Force Survey

Graph 3.3.4: **Employment rate by educational attainment, 20-64 by background, 2014**



Source: Eurostat, Labour Force Survey

The qualification profile of non-EU born is below that of Austrian nationals. Those with tertiary qualifications are under-employed. In 2014, 43 % of Austrian residents born outside the EU had a low qualification level, compared with only 13 % of Austrians and 19 % of the second generation residents. This poor educational starting point reduces their labour market opportunities. While low qualifications seem to translate into employment rates comparable to the Austrian average, highly educated people with a foreign background, especially from non-EU countries have markedly lower employment rates than the Austrian average. Although the qualification level of descendants of non-EU immigrants is somewhat better than that of their parents, there is hardly any catch-up in the employment rate compared with similarly skilled people born in Austria whose parents were also born in Austria (see Graph 3.3.4).

A further problem is discrimination on the labour market. Both during the application process and in salary levels, foreigners in Austria are treated less favourably than comparable natives ([35]). Pooled data (2002-2012) from the European social survey showed that, in Austria, the rate of people who feel they have been discriminated against on the grounds of ethnicity, nationality or race was far above EU-27 average. In Austria, some 34 % of native-born people (aged 15-24) with two foreign parents and 22 % of foreign-born people (aged 15-64) stated that they had been discriminated against, compared with 21 % and 14 %, respectively, in the EU-27.

Some measures accompanying the labour market integration of people with a migrant background are already in place. The recognition procedure for tertiary qualifications was shortened in 2012 from six to three months. At the end of December 2015, the government

([35]) Hofer, H., Titlelbach, G., Weichselbaumer, R., Winter-Ebmer, R. (2013) sent a total of around 2 000 (fictional) applications, in which the applicants differed from each other only by name and photo, but not by education, professional career and citizenship. The (fictitious) people came from Austria, Serbia, Turkey, China and Nigeria. Applicants from Serbia had to apply 1.31 times more often than Austrians to be invited to an interview. Chinese people 1.37 times, Turks 1.46 times and Nigerians 1.98 times more often than Austrians. The authors found that the discrimination in salaries between comparable natives and foreigners is about 10 %.

proposed a comprehensive Recognition Act (*Anerkennungsgesetz*). The main aim of the proposal is to simplify the procedure for the recognition of foreign qualifications and to develop a new system for the assessment of foreign qualifications.

Pensions

The long-term fiscal sustainability of pensions is challenged by accelerating demographic ageing and the low effective retirement age. The old-age dependency ratio is expected to almost double by 2060 and pension expenditure to increase by 0.5 pp. of GDP (vs EU average of -0.2 pp.). Austria has the EU's sixth largest predicted increase in pension expenditure for the period 2013-2060. Therefore, in 2015, Austria was recommended to undertake structural measures to improve the long-term sustainability of its pension system. These included further restricting early retirement (see above), aligning the retirement age to changes in life expectancy, and bringing forward the harmonisation of the statutory retirement age for men and women.

Higher life expectancy is a key driver of higher pension expenditure. The longevity of the Austrian population increased between 1983 and 2013 by 8.2 years, reaching 81.3 years. Life expectancy for men is expected to increase to 84.9 years by 2060 and for women to 89.1 years. Recent figures from the federal financial framework 2016-2019 (*Bundesfinanzrahmen*) show a persisting challenge for pension sustainability in the short term as public financial support for the pension insurance scheme will increase by 28 %, from EUR 10.4 billion in 2014 to EUR 13.3 billion in 2019 ([36]). In the long term, the 2015 Ageing Report indicates a lower increase of pension expenditures by 2060 than projected in the 2012 Ageing Report. Linking statutory retirement age to life expectancy could help to reduce the budgetary impact, but no measures to this end have been taken so far.

The Austrian pension system provides comparatively high aggregate replacement ratios and median relative incomes of people aged 65+. Still, the at-risk-of poverty rates for elderly people (age groups 65+ and 75+) are higher than the EU average. Figures are particularly unfavourable for women.

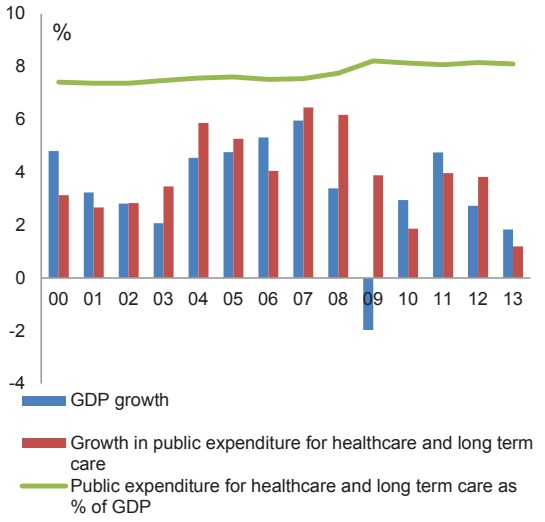
For women, a lower pensionable age, early retirement and career interruptions (often owing to care responsibilities) create a pension adequacy challenge. The gender pension gap widened from 35 % in 2008 to 39 % in 2014. Older women had an at-risk of poverty rate of 16.4 % vs 11.4 % for older men in 2014 – suggesting a somewhat higher gap than in the EU on average (11.2 % and 15.8 % for older women and older men). Harmonising the retirement ages would contribute to narrowing this divide and lowering the risk of poverty. In 2020, despite high life expectancy, Austria will have the lowest statutory retirement age for women in the EU. Its harmonisation with retirement age for men is currently scheduled to start in 2024 and end in 2033. No measures to accelerate it have been taken so far, despite its clearly predicted positive impact on pension adequacy. In order to avoid possible negative outcomes in the face of the rising unemployment of older workers, the increases in the pension age need to be accompanied by appropriate labour market measures (see above).

Health and long term care

The long-term fiscal sustainability of healthcare is challenged by accelerating demographic ageing given the current features of the system. The Austrian public healthcare system is one of the most expensive in the EU. It suffers from structural imbalances with an oversized hospital sector and an underdeveloped ambulatory care sector. An essential condition for improving the cost-efficiency of the healthcare system is to increase the use of primary care rather than hospital-based care. Austria continues to implement the health system reform plan (2013-2016) that will gradually cap the growth in public healthcare spending from 2016 to the annual average nominal GDP growth, which was forecast to be 3.6 % p.a. at that time.

([36]) The average annual increase of public expenditure on pensions is estimated at 4.2 %. 'Budgetdienst – Bundesfinanzrahmen 2016 – 2019' p. 74., in: http://www.parlament.gv.at/ZUSD/BUDGET/BD_-_Bundesfinanzrahmen_2016_-_2019.pdf

Graph 3.3.5: **Public healthcare and long term care expenditure growth and GDP growth**



Source: WHO

Taking general government spending on health and long term care as a reference, it appears that expenditure growth followed GDP growth in years of robust output growth (Graph 3.3.5). However, when the economy slowed down or specific events drove up public health and long term care expenditure, it was difficult to sustain this pattern. In particular, as the rate of growth observed since 2013 has been below what was initially estimated, the expenditure cap in force from 2016 may pose bigger challenges than expected (see also section 3.1.). Moreover, projections from the Ageing Report show an increase from 6.9 % of GDP in 2013 to 8.2 % of GDP in 2060 (+1.3 pps.) for healthcare. Age-related expenditure in Austria is currently estimated at 27.9 % of GDP and demographic factors could bring it up to 30.8 % of GDP in 2060 (+3 pps., compared with +1.5 pps. for the euro area) ([37]). The target of 1 % of patients for whom outpatient multidisciplinary primary care settings will be available by end of 2016 does not appear sufficiently ambitious ([38]). Excessively modest targets could restrict improvements in the sustainability of the system.

Demand for long-term care is rising. Expenditure is projected to increase from 1.4 % of GDP in 2013 to 2.6 % by 2060 (+1.3 pp.), based on which Austria qualifies as a relatively high spender, although below EU average. This corresponds to relatively high coverage rates in terms of population (3 %), especially as far as cash benefits are concerned (6 % of dependents). With a high share of the population receiving long-term care, a share of 37 % of dependents receiving long-term care is slightly lower than expected ([39]). In addition, Austria has high scores on the care needs index, hence a high potential need for long-term care. This points to a need to improve health, which would have the effect of reducing the incapacity/dependency ratio, and thus the need for long-term care benefits.

The government evaluates the quality of long-term care provision in households and is taking steps to increase quality assurance. By tightening access to long-term care cash benefits in the two lowest benefit levels, the government reduced the number of new benefit recipients in 2015. The estimated savings of EUR 19 million in 2015 and EUR 57 million in 2016 are planned to be used to generally increase the level of long-term care cash benefits in 2016. Tightening access to the first two levels of long-term care benefits will reduce the number of eligible beneficiaries and might have a negative impact on the employment of women, putting more pressure on them to leave their jobs in order to provide informal, family-based care. So far, the Long-Term Care Fund has been extended until to 2018.

A debt sustainability analysis by the Commission based on its autumn 2015 forecast assesses Austria as facing medium fiscal sustainability risks. Over the short term (in 2016) Austria does not appear to face risks of fiscal stress. In a no-policy-change scenario, the Austrian public debt is projected to decrease by more than 10 pps. of GDP between 2017 and 2026, reaching 74.7 % of GDP. The relative high level of public debt projections in 2026 qualifies Austria as being at medium risk in the medium term from a debt

([37]) https://www.bmf.gv.at/wirtschaftspolitik/in-oesterreich/langfristige-herausforderungen.html

([38]) E.g. only a fraction of diabetes patients in Austria (8.9 % of the population) could be covered, possibly avoiding hospital admissions for uncontrolled diabetes, which are particularly high in Austria, even if adjustments are made for prevalence, in: OECD (2012), 'Health at a Glance: Europe 2012', OECD Publishing.

([39]) Based on national data that are not fully comparable.

sustainability perspective ([40]). In order to reach the 60 % debt-to-GDP ratio by 2030, a cumulated gradual improvement in the structural primary balance of 1.6 % of GDP over five years (until 2022) would be required. This is mainly due to the unfavourable current level of debt and, to a lesser extent, to an age-related effect. In the long term, the projections point to a required fiscal adjustment of 3 % of GDP to ensure the sustainability of public finances, qualifying Austria as facing medium fiscal sustainability risks. This is mainly due to the strong projected impact of age-related spending (2.4 % of GDP).

([40]) More details on the fiscal sustainability assessment for Austria are available in European Commission (2016), 'Fiscal Sustainability Report 2015', Institutional Paper 18.

3.4. EDUCATION AND INTEGRATION

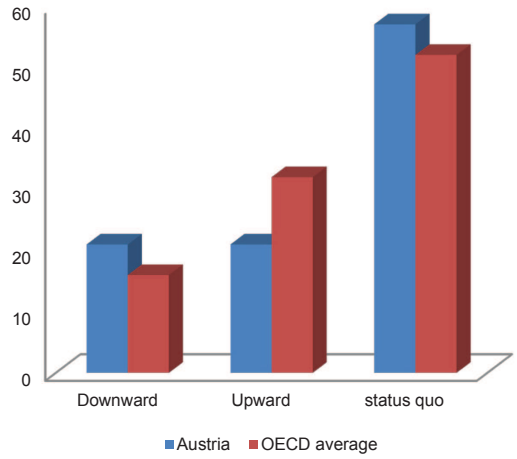
Education

Socioeconomic background continues to have a negative impact on the educational outcomes of young people in Austria, in particular those with a migrant background. Untapped educational potential results in lower employment rates and a lack of skills is an impediment to economic growth and to the successful integration of migrants. Taking into account the rising numbers of students, Austrian higher education is not sufficiently funded to carry out further reforms.

Young people at a socioeconomic disadvantage and/or with a migrant background continue to perform significantly worse in school than other students. The early school leaving rate has been declining continuously over recent years and is well below the EU average (7.0 % compared with 11.1 % in 2014). Foreign-born students in Austria are, however, still three times more likely to leave school early than native-born students (14.9 % compared with 5.7 % in 2014). While the proportion of young people who are not in employment, education or training (NEET) in 2014 was one of the lowest in the EU (7.7 %), for young people born in a non-EU country it was more than twice as high as for native-born people (16.1 % compared to 6.8 %). In this respect, according to Eurostat data, Austria is performing worse than comparable countries such as Denmark (7.8 % vs 5.6 % respectively) and Sweden (9.5 % vs 6.7 %). Students' performance in the basic skills was shown to have improved in the 2012 OECD Programme for International Student Assessment (PISA). Performance in reading remains somewhat below the EU average, however, with 19.5 % of students performing poorly compared with 17.8 % in the EU as a whole. In mathematics and science, the proportion of low achievers is below the EU average (18.7 % and 15.8 %, respectively, in Austria, compared with EU averages of 22.1 % and 16.6 %). Students from migrant backgrounds (foreign-born and the children of migrants), who constitute a large and growing proportion of students, score less well.

Intergenerational mobility in education is relatively low. Austria is one of the few countries where second-generation migrants perform worse than the first generation: only 29 % of the 25- to 64-year-olds who have finished education have higher educational attainment than their parents. Austria ranks 23rd out of the 23 countries for which data are available on this indicator. This is also confirmed by comparing the influence of educational level of parents on the selection of schools in Austria. Comparative data based on the censuses of 1981 and 2011 show that there has been little change in the influence of educational qualification of parents on choice of school type. In 2011, children of parents who had not finished upper secondary school were 86 % less likely to attend *Gymnasium* (selective secondary school) than the children of parents who did so. Compared with the children of parents with an academic degree, the difference was 93 %.

Graph 3.4.1: **Intergenerational mobility of Austrian students aged 25-34, 2012**



Source: OECD Education at a Glance 2015, Table A4.1.1a

Early childhood education and all-day schooling can help reduce negative socioeconomic effects as long as they are of good quality and their availability is ensured. Children from a disadvantaged socioeconomic background are often difficult to reach. Early childhood education lacks a comprehensive national curriculum and adequately trained staff ([41]). All-day schooling with a full-day curriculum and compulsory all-day attendance is expanding slowly and only 2.4 % of 6- to 14-year-olds attended an all-day school in 2012/13. The introduction of the new secondary school (*Neue Mittelschule, NMS*) has not yet had the expected

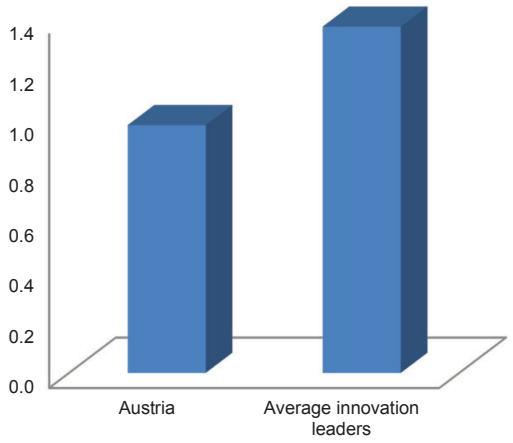
([41]) Austria is one of the very few countries not generally training educators in early childhood education at bachelor or master level.

impact on reducing the negative effects of socioeconomic background. The government's evaluation of March 2015 showed only mixed results ([42]). Though the school environment has improved overall, the level of educational achievement of disadvantaged groups has not improved compared with the *Hauptschule*, the type of school being replaced.

Austria increasingly acknowledges the importance of improving education outcomes by strengthening quality in compulsory education and early childhood education. The November 2015 reform proposals ([43]) provided some key elements to address these challenges. Starting early with compulsory analysis of the competencies of each child (at age 3½), a second compulsory year for four-year-olds is combined with a new transition phase between early childhood education and primary school. According to the outline of the reform, a national quality framework for early childhood education should be developed together with the federal states in 2016 and implemented by 2025. Increased autonomy of schools and of heads combined with intensified quality management is intended to improve educational outcomes. To combat early school leaving, Austria plans to implement a new measure entitled, 'Training up to 18' (*Ausbildung bis 18*).

Although it has reached its tertiary attainment target, Austria lacks graduates in science, technology, engineering and mathematics (STEM) and its higher education system suffers from funding constraints. Tertiary attainment among 30- to 34-year-olds reached 40 % in 2014, surpassing the Europe 2020 national target of 38 % ([44]). However, Austria does have comparatively fewer STEM graduates at Masters and PhD level than comparable industrialised countries ([45]). This could limit its ambition to further develop as a high technology economy and become an innovation leader.

Graph 3.4.2: **PhD Graduates of science, technology, engineering and mathematics (STEM) in 2013 – Austria compared with the average of innovation leaders (Denmark, Finland, Germany, Sweden), per 1000 habitants**



Source: Eurostat

Austria's higher education institutions continue to face increasing student numbers, and the Austrian Research Council considers universities to be underfunded ([46]). While funding increased between 2007 and 2012 by 29 %, student numbers went up by 44.3 %. Funding of Austrian higher education is sufficient to keep the system going but not to engage in further reforms, like capacity-based financing (i.e. to cost each student and to provide financing for a fixed number of students combined with access control to limit the number of students to the number of available places). This innovation would end the current situation where universities

([42]) Eder, F., Altrichter, H. et. al, (2015), 'Evaluation der Neuen Mittelschule. Befunde aus den Anfangskohorten.'

([43]) Bildungsreformkommission, Vortrag an den Ministerrat, 17. November 2015.

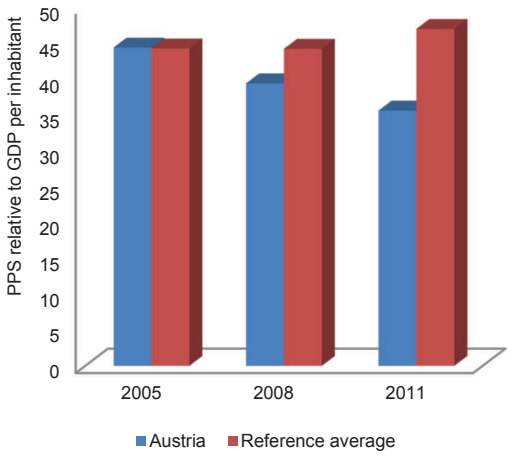
([44]) This was, however, in part due to a reclassification of qualifications stemming from higher technical and vocational colleges introduced in ISCED (International Standard Classification of Education) 2011. The new ISCED 2011, implemented in the EU Labour Force Survey for the first time in its 2014 annual data, has created a break in series for data on Austria's tertiary education attainment (ISCED 2011 levels 5 to 8). This makes it more difficult to assess the real level of progress.

([45]) Eurostat [educ_uoe_grad04] Austria has overall 21.8 % (Germany 17.2 %) tertiary education STEM graduates, but 8.9 % from short-cycle programmes (Germany 0 %), 6.5 % from bachelors programmes (Germany 10.2 %), 5.4 % from masters programmes (Germany 5.8 %) and 0.9 % from doctoral programmes (Germany 1.2 %).

([46]) Österreichischer Wissenschaftsrat (2013), 'Analyse der Leistungsvereinbarungen 2013-2015 und Stellungnahme' (http://www.wissenschaftsrat.ac.at/news/LV_2013_2015_Endversion.pdf). The total budget allocation for higher education institutions increased from EUR 6.2 billion over the period 2007-09 to EUR 8 billion for the period 2013-15. At the same time, student numbers increased from 261 000 in 2007 to 376 500 in 2012.

have to accept students irrespective of the available resources in most study areas. In March 2015, the Austrian Higher Education Conference presented a recommendation on improvements to the quality of higher education teaching (*Qualität der Lehre*). It addressed issues including the ability of individual teachers, the courses offered by universities, the organisation of learning and teaching and the efficiency of the higher education system. Although these recommendations are not binding, the government plans to use them as a reference for future performance agreements.

Graph 3.4.3: **Annual expenditure on tertiary education, per full-time student, in purchasing power standard (PPS) relative to GDP per inhabitant 2005/2008/2011**



Source: Eurydice (2015) The European Higher Education Area 2015

Integration

People with a migrant background continue to have less favourable outcomes on the Austrian labour market and in education system (see section 3.3. on labour market and section 3.4. on education). The current influx of refugees and migrants will represent a further challenge for integration.

In relation to the size of its population, Austria is one of the countries which have been most affected by the recent influx of refugees and migrants. An increase in the number of people entitled to asylum is expected in the coming months. The increased inflow of refugees and migrants will have marginal positive effects on GDP through higher consumption and additional government expenditure. In 2015 and 2016 only some of the arriving refugees and migrants are expected to enter the labour market, which means there will be only small overall impact on employment ([47]).

People who were granted asylum or subsidiary protection status have unrestricted access to the Austrian labour market. Their successful labour market integration depends on immediate access to German language training and establishing their skills profile at an early stage. At the moment, little is known about the qualifications profile of people seeking asylum in Austria ([48]).

Prior to being granted asylum or subsidiary protection status access to the labour market is particularly difficult. During the first three months of the asylum procedure, employment is not allowed. After that period, access to the labour market is granted selected sectors such as gastronomy and agriculture, and only if no Austrian or EU citizen takes the job. The budgetary plan 2016 provides an additional EUR 70 million for the labour market integration. The government is currently discussing an easier and earlier labour market access for refugees and migrants, but there are no concrete legislative proposals in preparation.

The recent significant inflow of refugees and migrants will also pose new challenges for the education system. Compulsory school attendance

([47]) A recent study commissioned by the Austrian Social Ministry came to the conclusion that liberalisation of the access to the labour market for refugees and migrants would have only a moderate effect on the labour market. If refugees and migrants accessed the labour market within 6 or 9 months of starting the asylum procedure, this would over, 4 years lead, to an increase of unemployment of only 0.1 to 0.2 pps.; if the labour market were open to refugees and migrants already after 3 months, unemployment could be expected to rise by 0.23 pps. See: Bock-Schappelwein, Julia / Huber, Peter (2015), 'Auswirkungen einer Erleichterung des Arbeitsmarktzuganges für Asylsuchende in Österreich', WIFO Wien.

([48]) In order to gather more information on the skills of the refugees and migrants, the public employment service has launched a skills check ('Kompetenzcheck'). The pilot phase involving 898 participants showed that education levels differ depending on the country of origin. While for Syria and Iran, the proportion of highly educated people exceeds that of Austrians, for Afghanistan it was very low. The pilot covered 5 weeks of testing during the second half of 2015.

applies irrespective of the child's residence status. However, young refugees and migrants arriving in Austria who are above the compulsory school age will need adequate education provision that is not yet on offer. Currently, some 6 000 children are to be integrated into the compulsory school system, creating a need for additional resources: teacher training, multilingual classrooms and qualified support for traumatised children. There is also a need to better integrate educational and social services and to increase the number of psychological service staff in the education system. One crucial factor for their future success in the education system is sufficient knowledge of the German language. The number of children who have not sufficiently mastered the language of instruction in school already increased significantly in Austria between 2011/12 and 2013/14: in primary schools by 15 %, in lower secondary schools by 38 % and in Gymnasiums by 31 %.

3.5. PROMOTING LONG-TERM GROWTH

Services sector

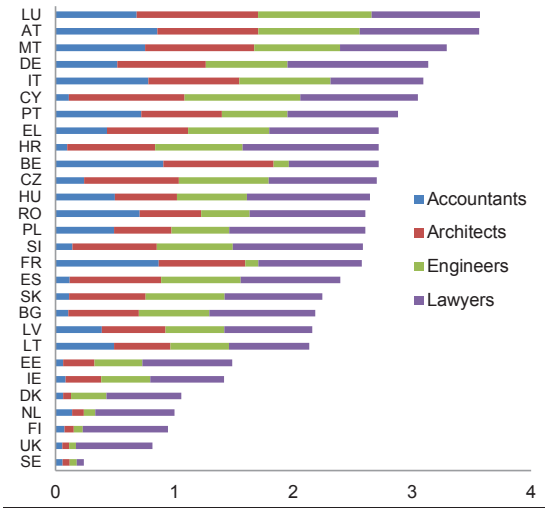
Austria continues to face restrictions on setting up multidisciplinary companies. Austria set up an inter-ministerial working group in November 2015 to develop proposals to address multi-disciplinary restrictions. Austria has furthermore agreed to remove Austrian company statutory seat (headquarters) requirements for civil engineers, architects and patent attorneys.

The action plan submitted by Austria as a result of the mutual evaluation on access and practise requirements for regulated professions concludes that there is little need for reform. Austria has actively participated in the mutual evaluation on access and practise requirements for regulated professions. The action plan submitted by Austria as a result of the mutual evaluation on access and practise requirements for the regulated professions presents a new post-evaluation instrument introduced in 2013 for every new legal act and a new harmonised electronic registration system for trades. However, the ambition and willingness to modernise the regulated professions and to adapt them to new economic challenges is lacking in general. A recent EU wide survey ([49]) indicates that 22 % of Austrian labour force can be considered as working in regulated professions. This is just above the EU average (21 %) and shows the economic importance of the regulated professions for the Austrian economy as well as the potential impact that changes to the regulatory framework could have on the sectors concerned.

Austria remains one of the Member States with high regulatory barriers in business services. An in-depth assessment of the regulation of business services published by the Commission in October 2015 ([50]) shows that Austria has the second most restrictive regulation in the EU in relation to accountants, architects, engineers and lawyers, which together form an important part of the business services sector. Graph 3.5.1 summarises regulatory restrictiveness on a scale of 0 (no restrictions) to 6 (most restrictive).

Restrictive authorisation requirements and restrictions on legal form, shareholding and multidisciplinary activities create difficulties for the establishment of service providers in Austria**.** Authorisation for access to and the practising of important business services is often subject to a specific exam (e.g. for architects and engineers) and insurance coverage (e.g. for accountants and lawyers), in addition to professional qualification requirements. Specific legal forms are in place for the practising of certain professions as a legal person, combined with strict shareholding requirements and multidisciplinary restrictions (e.g. for architects, engineers and lawyers).

Graph 3.5.1: **Regulatory restrictiveness of business services**



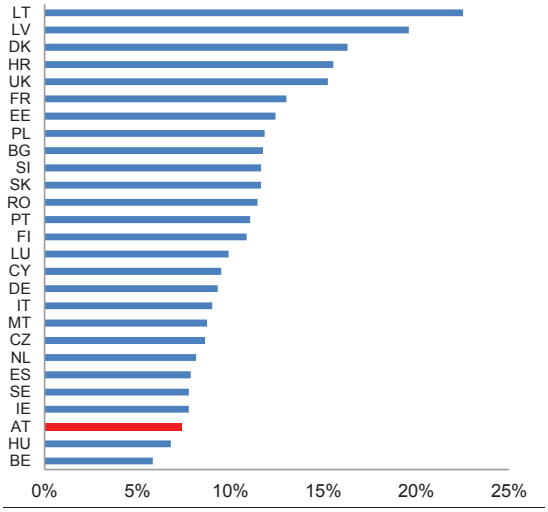
Source: European Commission: Business Services: Assessment of Barriers and their Economic Impact; October 2015

At the same time, Austria is experiencing subdued market dynamics and low competition in business services. Market entry rates of new businesses stand significantly below EU averages. Graph 3.5.2 shows the number of new businesses joining the business services market as a proportion of the total number of enterprises active in that market, with Austria having the third lowest entry rate of all the Member States.

([49]) TNS Opinion, 'Measuring the prevalence of occupational regulation: ad-hoc survey for the European Commission', April 2015, forthcoming.

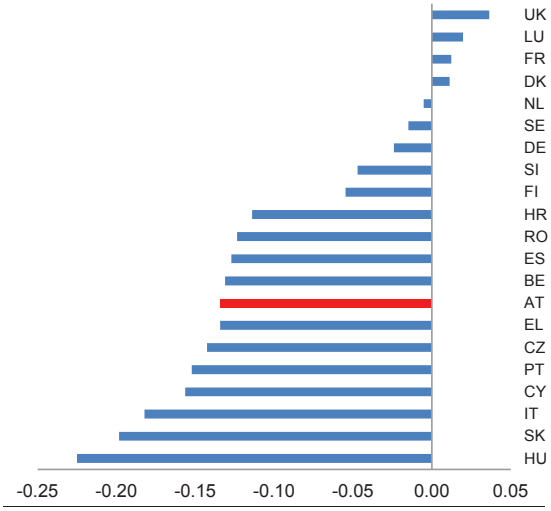
([50]) European Commission: Business services – Assessment of Barriers and their Economic Impact, October 2015, http://ec.europa.eu/growth/single-market/services/economic-analysis/index_en.htm

Graph 3.5.2: **Entry rates – professional, scientific and technical activities (2012).**



Source: Eurostat

Graph 3.5.3: **Allocative efficiency index – professional, scientific and technical activities (2013)**



Source: European Commission

Some services sectors which are highly regulated have seen negative productivity growth in Austria in recent years, endangering the competitiveness of these sectors. Until 2013, wage adjusted labour productivity in professional, scientific and technical activities went down to 92.3% (2008=100%) and to 91.8% in legal and accounting activities. Barriers are impeding an efficient allocation of resources to their most efficient use in important business services sectors. This is confirmed by a negative level of allocative efficiency in these sectors ([51]). Graph 3.5.3 shows the extent to which production factors are allocated towards their most efficient use, based on the market shares of more productive firms compared with less productive firms within the sector. Austria's negative allocative efficiency value in the business services sector points to constrained market dynamics preventing more competitive firms from increasing their market share.

Business services are an important input to Austrian industry. Over 12 % of the value created by Austrian manufacturing is created by business services inputs ([52]). Improving the performance of business services would therefore also have a positive effect on Austrian industry.

([51]) Allocative efficiency is defined as the extent to which productive factors are allocated towards their most efficient use. In that sense, it is particularly relevant to assess productivity. More information on the methodology of allocative efficiency can be found in: European Commission (2014), 'The Economic Impact of Professional Services Liberalisation', Economic Papers 533.

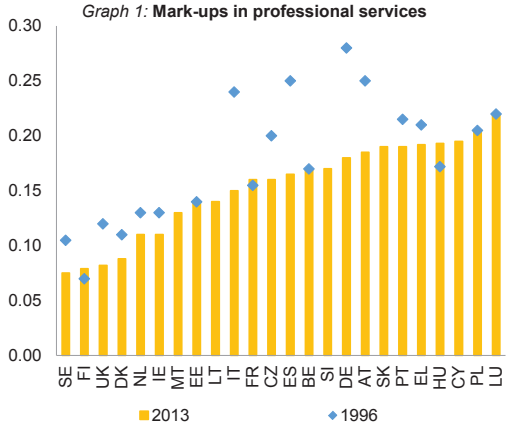
([52]) 'Study on the relationship between industry and services in terms of productivity and value creation', Study for the European Commission, ECSIP Consortium, 2014.

Box 3.5.1: Competition in professional services

Potential impact of structural reforms – closing-the-policy-gap

This box presents the estimated macroeconomic impacts of a country adopting better practices. Two performance indicators are used, namely mark-ups and allocative efficiency in professional services ([1]). These are linked to the OECD's policy indicator, Product Market Regulation (PMR) where higher values indicate stricter regulation. Analysis by the Commission has investigated the links between PMR and mark-ups ([2]), and PMR and allocative efficiency ([3]). Sweden was chosen as the benchmark. The analysis shows that if Austria were to have the same level of PMR in professional services as Sweden, the mark-up in Austria could fall from 20 % to 9 %, thus eliminating the performance gap with Sweden (see Graph 1). Using the PMR for the various sub-sectors, closing the policy gap would mean a predicted impact on business churn of more than 5 pps. for legal activities, which in turn would improve the allocative efficiency by 0.18. This is equal to an increase in average labour productivity in the sector of 14%, which is the predicted reform impact if Austria had a similar regulatory framework as Sweden. The productivity gain would be around 3% for accounting activities and 11% for architecture and engineering.

Graph 1: **Mark-ups in professional services**



Source: ECFIN (2015)

The potential macroeconomic implications are assessed based on a 3-region (Austria, rest of the euro area, rest of the world) version of the QUEST model, which distinguishes between tradable and non-tradable sectors. For a detailed description of the model structure, see Vogel (2014) ([4]). The simulations use the estimates for the labour productivity gains and mark-up reductions as input. The effects are scaled by the share of the sub-sectors in total GDP to obtain aggregate labour productivity and mark-up shocks. As some professional services are tradable, the reform is not confined to the non-tradable sector of the economy. The labour productivity and mark-up effects are phased in gradually over a period of five years, reflecting that the effects of reforms need time to materialise fully.

The results in Table 1 suggest GDP gains of approximately 0.9 % in the long term that materialise gradually. Consumption and investment increase; the investment increase is more pronounced to sustain a higher capital stock associated with higher returns on capital. Employment remains fairly stable. The long-term GDP level effect of 0.7 % after 10 years is rather large given the limited share (4 %) of professional services in total GDP. Its strength can be attributed to the underlying assumption of closing the policy gap with Sweden, which is indeed a drastic policy change. This simulation therefore shows the *potential* economic impact of regulatory reform.

If the UK is chosen as the benchmark the results are very similar. For example, the GDP effect after 10 years would be equal to 0.65 and the consumption effect after 10 years would be equal to 0.20.

([1]) A more elaborate description of the allocative efficiency indicator can be found in European Commission (2013), 'Product Market Review 2013: Financing the real economy', European Economy 8|2013.
([2]) European Commission (2015), 'Estimation of service sector mark-ups determined by structural reform indicators', Economic Papers, No 547.
([3]) European Commission (2014), 'The economic impact of professional services liberalisation', Economic Papers, No 533.
([4]) Vogel, L. (2014), 'Nontradable sector reform and external rebalancing in monetary union: A model-based analysis', Economic Modelling, vol. 41(C), pp. 421-434.

(Continued on the next page)

Box (continued)

Table 1:

Productivity improvement and mark-up reduction spread across tradable and non-tradable sectors (Sweden benchmark)

Year	1	2	3	4	5	6	7	8	9	10	20	50
Real GDP	-0.02	0.08	0.23	0.37	0.50	0.58	0.63	0.65	0.66	0.68	0.78	0.89
non-tradables	-0.07	-0.03	0.07	0.18	0.28	0.35	0.39	0.41	0.43	0.44	0.54	0.64
tradables	0.07	0.24	0.41	0.56	0.68	0.76	0.79	0.80	0.81	0.82	0.96	1.11
Employment	-0.03	-0.02	0.03	0.07	0.09	0.10	0.10	0.09	0.09	0.08	0.07	0.07
Consumption	-0.25	-0.33	-0.25	-0.13	-0.02	0.08	0.15	0.19	0.22	0.23	0.31	0.38
Investment	0.20	0.52	0.84	1.11	1.33	1.46	1.52	1.54	1.53	1.51	1.39	1.31
Trade balance	0.02	0.04	0.06	0.06	0.05	0.03	0.01	0.00	-0.02	-0.03	-0.03	0.00

Source: Eurostat, European Commission
Note: Results for GDP, consumption and investment are % deviations and results for the trade balance are percentage-point deviations of net trade to GDP from pre-reform levels.

Federal competition authority

Compared with competition authorities in other Member States, the Federal Competition Authority is under-resourced and this impedes more effective action. The budget situation has not changed in comparison with previous years and therefore the authority will not be able to increase the number of staff. On 4 November 2015, the Commission launched a public consultation on empowering the national competition authorities (NCAs) to be more effective enforcers of EU competition rules. The Commission aims to gather feedback from a broad range of stakeholders to further strengthen the enforcement and sanctioning tools of NCAs. The public consultation covers matters such as guaranteeing that NCAs are sufficiently independent and have appropriate resources when enforcing the EU competition rules. The Commission is carefully reviewing all input received during the public consultation in order to decide whether and to what extent it should take further action at European level.

Business environment

Lack of sufficient rules and procedures allowing national companies to directly transfer their registered office abroad (or enabling foreign companies' transfers to Austria) weakens the business environment. Such transfers are not possible under national legislation, except for European Companies (SEs). This can make it more difficult for companies to relocate and therefore take advantage of business opportunities. Foreign companies risk being refused registration in Austria, and even national ones may need to navigate a complex and costly process of winding-up in Austria and reincorporating abroad. Firms will also face additional procedures and costs if they try to transfer indirectly (e.g. by merging into a foreign subsidiary – cross-border merger costs could be around EUR 35 000 per company according to the 2013 European Added Value Assessment on cross-border transfers of registered office – or by converting into a European Company, which would include meeting the minimum capital requirement of EUR 120 000).

Access to finance

Austria has no short-term bottlenecks regarding access to finance for businesses but risks underachieving its growth and jobs potential through lack of sufficient, reliable and diverse financing options for SMEs and start-ups. The ECB Surveys of 2014 and 2015 on the access to finance of enterprises in the euro area (SAFE) show that the rejection rate of loan requests by Austrian SMEs is amongst the lowest in the EU (6.5 %) and that access to finance is ranked by Austrian SMEs as a low concern compared to most other euro area Member States (approx. 7 %).

While there is no shortage of individual measures (including to promote equity financing), a consistent approach across financial and capital markets is lacking. For instance, the spectrum of capital markets, which in practice are closely related to one another, has gaps that prevent smooth transitions between different enterprise development phases. In Austria, these gaps are mainly caused by the still insufficient size of venture capital and private equity markets, underdeveloped exit opportunities

for crowd investments, and the insufficient attractiveness of the initial public offerings of SMEs, and small- and mid-caps.

Since 2007, the percentage of venture capital and private equity fund volumes in Austria as a proportion of GDP has decreased by more than two thirds. This decrease happened despite the fact that the public sector already carries out a disproportionately high share of investment due to the weakness of private financing. The main weakness is the below average mobilisation of own funds within Austria – the inflow of risk capital is much higher than the outflow, which suggests there are enough suitable projects to invest in. The availability of venture capital remains slightly below EU average (0.019 % of GDP in 2014 versus 0.024 % at EU level) and clearly below the levels observed in the Nordic countries ([53]). 88 % of Austrian SMEs do not consider equity capital as relevant for their enterprises. This hints at a high dependence of Austrian firms on traditional debt financing.

Regarding crowdfunding, Austria adopted an alternative financing law ('Alternativfinanzierungsgesetz') in August 2015. This law facilitates crowdfunding by introducing lighter prospectus requirements and is a bold step – even in EU comparison – towards extending the range of available sources of finance. However, the potential of this reform can only be tapped if it is accompanied by educational measures that help develop an alternative finance culture (and, more broadly, an equity culture) in Austria. This applies not only to commercial activities in manufacturing and service sectors but also to the promotion of social entrepreneurship. Here, encouraging a more active role of family offices and foundations would tap additional sources of finance.

Similarly, public capital markets are underperforming in offering access to capital markets for SMEs and mid-caps. Such markets play a pivotal role in offering exit options through e.g. initial public offerings. However, a high administrative burden caused by regulation, insufficient research on listed SMEs in Austria, and thus too little visibility of listed companies for potential investors, form bottlenecks that prevent young market sectors from growing. In 2013 and 2014, public capital markets saw negative growth rates, in contrast to the EU average.

Public procurement

At least since 2011, Austria has had one of the lowest EU publication rates for public procurement contracts advertised at EU level. In 2014, the share of public contracts for works, goods and services (including utilities and defence) published by the Austrian authorities and entities under EU procurement legislation was only 2.30 % of GDP. Despite an increase compared with 2013, it is still well below the EU average of 4.39 %. Increasing this rate by further opening up the procurement market would bring more competition and lead to economic benefits, such as better value for public money.

Research and innovation

While Austria shows a high level of public and private R&D funding, there is scope for increasing its innovation performance. R&D spending as a percentage of GDP in Austria amounted to 2.99 % in 2014, the fourth highest level in the EU. Austria is also among the EU countries with the strongest increase in R&D intensity since 2000 (Graph 3.5.4), as a result of increases in both business and public R&D expenditure (though progress has decelerated in recent years, especially for public expenditure). Public spending on R&D cofinanced by private companies, an indicator for the level of public-private cooperation in R&D, accounted for 0.041 % of Austria's GDP in 2011, compared with an EU average of 0.051 %.

The growth of innovative firms in their start-up phase is below the EU average. According to Eurostat, fast growing firms represented only about 7.4 % of employment in the business economy in 2013, compared with an EU average of about 10.7 %. Although particularly important for innovative firms, the markets for small-scale equity finance and crowdfunding ([54]), are still

([53]) Source: Invest Europe, in 2014 Venture capital in the 3 Nordic EU countries amounted to 0.050 % of GDP on average.

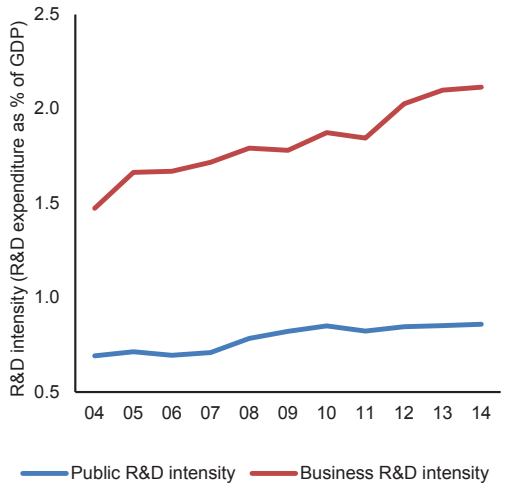
([54]) According to the European Commission Crowdfunding study of September 2015 in 2014 there were 18 crowdfunding projects per million inhabitants in Austria,

underdeveloped by comparison with other Member States (see also section 2.4.).

Austria is addressing the need to boost the performance of its research and innovation system in a national research, technological development and innovation strategy adopted in 2011 ('Der Weg zum Innovation Leader'). In 2015, a research action plan was published and new guidelines for research, technology and innovation funding entered into force on 1 January 2015. In line with a shift from direct to indirect support such as tax incentives, the research premium was increased from 10 % to 12 % in January 2016. However, it is necessary to evaluate the effectiveness of these measures in comparison to direct support. In recent years, there have also been a growing number of initiatives focusing on improving knowledge transfer and cooperation between public research (including at universities) and business.

compared to 254 in the EU. The money raised amounted to 0.27 € per capita in Austria compared to 3.09 € in the EU.

Graph 3.5.4: **Developments in business R&D intensity and public R&D intensity, 2000-2014**



Notes: (1) Business R&D intensity: Business enterprise expenditure on R&D (BERD) as % of GDP.
(2) Public R&D intensity: Government intramural expenditure on R&D (GOVERD) plus higher education expenditure on R&D (HERD) as % of GDP.

Source: Directorate-General for Research and Innovation — Unit for the Analysis and Monitoring of National Research Policies

In 2015, the Federal Ministry of Science, Research and Economy issued the 'Land of Founders' strategy with the ambitious goal of turning Austria into the most attractive location for start-ups in Europe. The new law on crowdfunding that was passed in 2015 has significantly liberalised the regulation of retail investment. In addition, the Austrian government provides direct support to boost venture capital. However, this has not yet translated into higher overall venture capital usage figures.

Resource efficiency

Austria fully recognises the impact the circular economy and resource efficiency can have on EU policy objectives. It has adopted a specific resource efficiency action plan, and is one of only three Member States to have a dedicated national strategy. Resource-efficient production, public procurement, the circular economy and awareness-raising are the main action areas. It aims to improve resource productivity by 50 % by 2020 (compared with 2008). In its 'Environmental Performance Reviews Austria 2013', the OECD states that Austria generates more economic wealth

in relation to used material than the EU average. However, Austria's economy is heavily dependent on imports of raw materials, partly for domestic consumption but also for exports. The rate of material consumption, at 20.1 tonnes per capita, is above the EU average of 13.3 tonnes per capita. As resource productivity is also below the EU average, Austria would need to make additional efforts if it is to reach its long-term resource efficiency targets.

Greenhouse gas emissions

According to Austria's latest projections, emissions from road transport will increase between 2013 and 2020 ([55]). Austria is expected to miss its 2020 target on greenhouse gas emissions not covered by the EU emissions trading scheme by 4 pps. ([56]). In light of these projections, Austria adopted additional mitigation measures under its programme of policies and measures for 2015-2018, aimed in particular at reducing emissions in the transport sector for which the emissions share is far above the EU average ([57]). Projections factoring in the additional measures submitted by Austria show that the target will be met if the measures are implemented successfully.

Electricity and gas networks

Active regional cooperation and faster permit granting remain critical to the development and operation of the electricity and gas networks. The high-tension 380-kV ring in Austria is not yet completed and the planned cross-border capacities in particular with Germany, Italy and Switzerland, need to be implemented swiftly. While permit granting is the largest barrier to implementation, the regulatory framework does not yet sufficiently encourage transmission system operators to invest. The current national arrangements for congestion management and bidding zone definition in central Europe do not necessarily reflect actual congestion accurately, and this is leading to increasing limitations on cross-border flows of electricity. The issue lacks a joint regional solution agreed by all affected neighbours.

([55]) See Umweltbundesamt 'Klimaschutzbericht 2015' (http://www.umweltbundesamt.at/fileadmin/site/publikationen/REP0555.pdf), p. 60. The projected increase in road transport emissions varies from 0.5 and 0.7 Mio. t Carbon dioxide equivalent.

([56]) See European Environment Agengy Report, 'Trends and projections in Europe 2015 — Tracking progress towards Europe's climate and energy targets' No 4/2015 (http://www.eea.europa.eu/publications/trends-and-projections-in-europe-2015/#parent-fieldname-title) p. 32.

([57]) See COM(2015)572 – Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee, the Committee of the Regions and the European Investment Bank – State of the Energy Union 2015 (Austria) (http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=COM:2015:572:FIN), p. 9.

ANNEX A

Overview table

Commitments	Summary assessment ([58])
2015 Country-specific recommendations (CSRs)	
CSR 1: Avoid deviating from the medium-term objective in 2015 and 2016. Ensure the budget neutrality of the tax reform aimed at reducing the tax burden on labour. Correct the misalignment between the financing and spending responsibilities of the different levels of government. Take measures to ensure the long-term sustainability of the pension system, including by earlier harmonisation of the statutory retirement age for men and women and link the statutory retirement age to life expectancy.	Austria has made **limited progress** in addressing CSR 1 (this overall assessment of CSR 1 does not include an assessment of compliance with the Stability and Growth Pact): • **Some progress** in ensuring the budget neutrality of the tax reform as several financing measures have been implemented. However, these consist to a large extent in measures against tax fraud, the yields of which are intrinsically uncertain. • **Limited progress** in correcting the misalignment between the financing and spending responsibilities of the different levels of government as no concrete proposals have been put forward so far, although accounting rules for sub-national governments have been harmonised (effective as of 2019/2020). • **Limited progress** in ensuring the long-term sustainability of the pension system. The effective retirement age has risen, but it still remains below the statutory retirement age. Furthermore, the positive budgetary effects of the measures taken to restrict access to early retirement still need to materialise. • **No progress** in the earlier harmonisation of the statutory retirement age for men and women. • **No progress** in linking the statutory retirement age to life expectancy.
CSR 2: Strengthen measures to increase the labour market participation of older workers and women,	Austria has made **limited progress** in

([58]) The following categories are used to assess progress in implementing the 2015 CSRs:
No progress: The Member State (MS) has neither announced nor adopted measures to address the CSR. This category also applies if the MS has commissioned a study group to evaluate possible measures.
Limited progress: The MS has announced some measures to address the CSR, but these appear insufficient and/or their adoption/implementation is at risk.
Some progress: The MS has announced or adopted measures to address the CSR. These are promising, but not all of them have been implemented and it is not certain that all will be.
Substantial progress: The MS has adopted measures, most of which have been implemented. They go a long way towards addressing the CSR.
Fully implemented: The MS has adopted and implemented measures that address the CSR appropriately.

including by improving the provision of childcare and long-term care services. Take steps to improve the educational achievement of disadvantaged young people.	addressing CSR 2: • **Some progress** in increasing the labour market participation of older workers as active labour market policy for this group has been intensified and employers have been incentivised to provide age-friendly working conditions and employ older workers, although the employment rate of older workers remains below the EU average. • **Limited progress** in increasing the labour market participation of women as the provision and quality of childcare and all-day schools that are compatible with full-time employment remain inadequate. • **Limited progress** in increasing the labour market participation of women by providing long-term care facilities that are compatible with full-time employment. • **Limited progress** in improving the educational achievement of disadvantaged young people as socioeconomic background continues to have a negative impact on the educational outcomes of young people in Austria, in particular of those with a migrant background, although Austria increasingly acknowledges the importance of improving educational outcomes by proposing reforms aimed at boosting the quality of compulsory education and early childhood education. The recent reforms do not address early tracking (ability grouping) from the age of 10.
CSR 3: Remove disproportionate barriers for service providers and impediments to setting up interdisciplinary companies.	Austria has made **limited progress** in addressing CSR 3: • **Limited progress** in removing disproportionate barriers for service providers and impediments to setting up interdisciplinary companies. Austria has been assessing the proportionality of its regulated professions as part of the mutual evaluation of regulated professions. A new post-evaluation instrument for all legal acts has been introduced along with a new harmonised electronic registration system

	for trades. However, there will be no significant reforms of the existing regulated professions. An inter-ministerial working group was set up in November 2015 to develop proposals to address multi-disciplinary restrictions, but it has not yet presented any findings. Austria also indicated that it planned to remove restrictive statutory seat (headquarters) requirements for companies of architects, engineers and patent attorneys.
CSR 4: Address the potential vulnerabilities of the financial sector in terms of foreign exposure and insufficient asset quality.	Austria has made **some progress** in addressing CSR 4: • **Some progress** in addressing the potential vulnerabilities in the financial sector as supervisory measures have helped to limit the impact of deteriorating asset quality in the CESEE and CIS region on the profitability and capitalisation of Austrian banks, including improving their funding structure and contributing to the expansion of local funding sources.
Europe 2020 (national targets and progress)	
Employment rate target: 77-78 %	Employment rate for the population aged 20 to 64: 75.2 % in 2011, 75.6 % in 2012, 75.5 % in 2013 and 74.2 % in 2014. Given the current trend of the Austrian employment rate, it remains a challenge to meet the national target of 77-78 % by 2020.
R&D target: 3.76 % of GDP	R&D expenditure: 2.99 % (2014). According to estimates from Statistics Austria (April 2015) R&D intensity in 2015 increased slightly compared with 2014 to reach 3.01 %. Austria is one of the EU countries with the strongest increase in R&D intensity since 2000, as a result of increases in both business and public R&D expenditure. However, progress has decelerated in recent years, especially for public expenditure. Without additional efforts and faster progress, the ambitious 3.76 % target for 2020 will not be met.
National greenhouse gas (GHG) emissions target:	According to the European Environmental Agency's approximated data, Austria reduced

-16 % in 2020 compared with 2005 (in sectors not included in the Emissions Trading Scheme)	its greenhouse gas emissions not covered by the Emissions Trading Scheme (ETS) by 17 % between 2005 and 2014. According to recent projections and taking into account existing measures only, non-ETS emissions will decrease by 12 % between 2005 and 2020. The target is therefore likely to be missed by a margin of 4 pps. Austria is, however, planning and implementing additional measures to address this shortfall.
2020 Renewable energy target: 34 % 2020 Renewable energy in transport target: 10%	Austria continued to make good progress in promoting the use of renewable energy. Energy from renewable sources represented 33.1 % of Austria's energy consumption in 2014 (Eurostat), and the country is on track to meet its 2020 target of 34 %. With a share of 8.9 % in 2014, Austria is also well on track to meet its renewable energy in transport target.
Energy efficiency target: AT's 2020 energy efficiency target is 31.5 Mtoe expressed in primary energy consumption (25.1 Mtoe expressed in final energy consumption)	Austria has set itself an ambitious target for 2020. Austria has, in most sectors, made outstanding energy efficiency improvements, especially in the service and transport sectors (Energy Efficiency Progress Report COM(2015) 574 final). To deliver on the ambitious target, Austria will need to sustain the efforts and fully implement the national energy efficiency measures enacted under the Energy Efficiency Directive.
Early school/training leaving target: 9.5 %	Austria is already outperforming the Europe 2020 targets: 8.5 % in 2011 7.6 % in 2012 7.3 % in 2013 7.0 % in 2014 But efforts to reduce the early school leaving rate among young people with a migrant background must be maintained.
Tertiary education target: 38 %	Austria attained the 40 % target in 2014, mainly due the reclassification of upper secondary vocational education and training towards tertiary non-degree education in 'International Standard Classification of Education 2011' (2013, 27.3 %).
Risk of poverty or social exclusion target: -235 000	In the baseline year 2008, the number of people at risk of poverty and social exclusion was 1 699 000. The respective number for 2014 was 1 609 000, i.e. 90 000 less.

ANNEX B

MIP scoreboard

Table B.1: **MIP Scoreboard**

			Thresholds	2009	2010	2011	2012	2013	2014
External imbalances and competitiveness	Current account balance, (% of GDP)	3 year average	-4%/6%	3.7	3.3	2.4	2.0	1.7	1.8
	Net international investment position (% of GDP)		-35%	-5.1	-5.2	-1.9	-3.1	1.3	2.2
	Real effective exchange rate - 42 trading partners, HICP deflator	3 years % change	±5% & ±11%	2.0	-2.0	-1.9	-4.7	0.7	1.9
	Export market share - % of world exports	5 years % change	-6%	-8.3*	-14.7*	-12.1	-21.3	-17.6	-15.7
	Nominal unit labour cost index (2010=100)	3 years % change	9% & 12%	10.3	8.9	5.9	3.7	6.3	7.8
Internal imbalances	Deflated house prices (% y-o-y change)		6%	3.4e	4.4be	3.0	4.9	3.0	1.4
	Private sector credit flow as % of GDP, consolidated		14%	1.3	0.3	3.0	1.3	0.6	0.2
	Private sector debt as % of GDP, consolidated		133%	132.8	132.9	130.1	128.9	127.7	127.1
	General government sector debt as % of GDP		60%	79.7	82.4	82.2	81.6	80.8	84.2
	Unemployment rate	3 year average	10%	4.8	4.7	4.9	4.8	5.0	5.3
	Total financial sector liabilities (% y-o-y change)		16.5%	-1.9	-2.0	1.5	0.3	-3.7	-1.5
New employment indicators	Activity rate - % of total population aged 15-64 (3 years change in p.p)		-0.2%	1.9	0.9	0.7	0.8	1.1	0.8
	Long-term unemployment rate - % of active population aged 15-74 (3 years change in p.p)		0.5%	-0.3	-0.1	0.2	0.0	0.1	0.3
	Youth unemployment rate - % of active population aged 15-24 (3 years change in p.p)		2%	0.9	0.1	0.4	-1.3	0.2	1.4

Flags: *: BPM5/ESA95 figure. b: break in time series. e: estimated.
Note: Figures highlighted are those falling outside the threshold established in the European Commission's Alert Mechanism Report. For REER and ULC, the first threshold applies to euro area Member States. ***Source:*** European Commission

ANNEX C
Standard tables

Table C.1: **Financial market indicators**

	2010	2011	2012	2013	2014	2015
Total assets of the banking sector (% of GDP)	332.2	327.3	307.5	283.0	267.2	254.2
Share of assets of the five largest banks (% of total assets)	35.9	38.4	36.5	36.7	36.8	-
Foreign ownership of banking system (% of total assets)	19.5	20.9	22.2	23.1	24.7	-
Financial soundness indicators:						
- non-performing loans (% of total loans)[1)]	2.8	2.7	2.8	2.9	3.5	3.6
- capital adequacy ratio (%)[1)]	15.4	15.8	17.0	18.0	16.3	16.5
- return on equity (%)[1)]	7.9	1.4	5.5	1.2	-3.2	4.7
Bank loans to the private sector (year-on-year % change)	0.3	2.0	0.8	-1.0	0.5	0.6
Lending for house purchase (year-on-year % change)	2.6	3.8	2.6	2.2	3.0	4.3
Loan to deposit ratio	110.9	108.8	107.4	103.4	100.5	99.6
Central Bank liquidity as % of liabilities	2.2	2.3	2.7	1.6	1.8	2.1
Private debt (% of GDP)	132.9	130.1	128.9	127.7	127.1	-
Gross external debt (% of GDP)[2)] - public	56.8	57.3	61.2	66.6	74.9	70.7
- private	40.8	37.5	40.0	33.1	35.2	36.6
Long-term interest rate spread versus Bund (basis points)*	48.2	71.1	87.8	44.0	32.4	25.0
Credit default swap spreads for sovereign securities (5-year)*	60.6	76.8	78.9	19.8	20.1	16.4

(1) Latest data Q2 2015.
(2) Latest data September 2015. Monetary authorities, monetary and financial institutions are not included..
* Measured in basis points.
Source: IMF (financial soundness indicators); European Commission (long-term interest rates); World Bank (gross external debt); Eurostat (private debt); ECB (all other indicators).

Table C.2: **Labour market and social indicators**

	2010	2011	2012	2013	2014	2015 (4)
Employment rate (% of population aged 20-64)	73.9	74.2	74.4	74.6	74.2	74.2
Employment growth (% change from previous year)	0.7	1.6	1.1	0.5	0.9	0.6
Employment rate of women (% of female population aged 20-64)	68.8	69.2	69.6	70.0	70.1	70.1
Employment rate of men (% of male population aged 20-64)	79.0	79.2	79.3	79.1	78.3	78.3
Employment rate of older workers (% of population aged 55-64)	41.2	39.9	41.6	43.8	45.1	46.0
Part-time employment (% of total employment, aged 15 years and over)	25.3	25.3	26.0	26.8	27.9	28.2
Fixed term employment (% of employees with a fixed term contract, aged 15 years and over)	9.4	9.5	9.3	9.2	9.1	9.1
Transitions from temporary to permanent employment	40.5	42.5	50.4	44.5	48.9	-
Unemployment rate(1) (% active population, age group 15-74)	4.8	4.6	4.9	5.4	5.6	5.7
Long-term unemployment rate(2) (% of labour force)	1.2	1.2	1.2	1.3	1.5	1.6
Youth unemployment rate (% active population aged 15-24)	9.5	8.9	9.4	9.7	10.3	10.2
Youth NEET(3) rate (% of population aged 15-24)	7.4	7.3	6.8	7.3	7.7	-
Early leavers from education and training (% of pop. aged 18-24 with at most lower sec. educ. and not in further education or training)	8.3	8.5	7.8	7.5	7.0	-
Tertiary educational attainment (% of population aged 30-34 having successfully completed tertiary education)	23.4	23.6	26.1	27.1	40.0	-
Formal childcare (30 hours or over; % of population aged less than 3 years)	3.0	3.0	7.0	8.0	-	-

(1) Unemployed persons are all those who were not employed but had actively sought work and were ready to begin working immediately or within two weeks.
(2) Long-term unemployed are peoples who have been unemployed for at least 12 months.
(3) Not in Education Employment or Training.
(4) Average of first three quarters of 2015. Data for total unemployment and youth unemployment rates are seasonally adjusted.
Source: European Commission (EU Labour Force Survey)

Table C.3: **Labour market and social indicators (continued)**

Expenditure on social protection benefits (% of GDP)	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**
Sickness/healthcare	7.4	7.3	7.2	7.3	7.4	-
Invalidity	2.1	2.2	2.1	2.1	2.1	-
Old age and survivors	14.2	14.3	14.1	14.4	14.7	-
Family/children	2.9	3.0	2.8	2.7	2.7	-
Unemployment	1.7	1.6	1.5	1.5	1.6	-
Housing and social exclusion n.e.c.	0.2	0.2	0.1	0.1	0.1	-
Total	28.8	28.8	28.1	28.4	28.9	-
of which: means-tested benefits	2.1	2.2	2.2	2.2	2.3	-
Social inclusion indicators	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**
People at risk of poverty or social exclusion[1] (% of total population)	19.1	18.9	19.2	18.5	18.8	19.2
Children at risk of poverty or social exclusion (% of people aged 0-17)	20.8	22.4	22.1	20.9	22.9	23.3
At-risk-of-poverty rate[2] (% of total population)	14.5	14.7	14.5	14.4	14.4	14.1
Severe material deprivation rate[3] (% of total population)	4.6	4.3	4.0	4.0	4.2	4.0
Proportion of people living in low work intensity households[4] (% of people aged 0-59)	7.1	7.8	8.6	7.7	7.8	9.1
In-work at-risk-of-poverty rate (% of persons employed)	8.2	7.5	7.6	8.1	7.9	7.2
Impact of social transfers (excluding pensions) on reducing poverty	42.7	43.5	46.5	44.2	44.4	44.5
Poverty thresholds, expressed in national currency at constant prices[5]	11641	11929	11956	11731	11576	11920
Gross disposable income (households; growth %)	0.3	0.7	2.9	4.4	0.2	2.6
Inequality of income distribution (S80/S20 income quintile share ratio)	4.2	4.3	4.1	4.2	4.1	4.1

(1) People at risk of poverty or social exclusion (AROPE): individuals who are at risk of poverty (AROP) and/or suffering from severe material deprivation (SMD) and/or living in households with zero or very low work intensity (LWI).
(2) At-risk-of-poverty rate (AROP): proportion of people with an equivalised disposable income below 60% of the national equivalised median income.
(3) Proportion of people who experience at least four of the following forms of deprivation: not being able to afford to i) pay their rent or utility bills, ii) keep their home adequately warm, iii) face unexpected expenses, iv) eat meat, fish or a protein equivalent every second day, v) enjoy a week of holiday away from home once a year, vi) have a car, vii) have a washing machine, viii) have a colour TV, or ix) have a telephone.
(4) People living in households with very low work intensity: proportion of people aged 0-59 living in households where the adults (excluding dependent children) worked less than 20% of their total work-time potential in the previous 12 months.
(5) For EE, CY, MT, SI and SK, thresholds in nominal values in euros; harmonised index of consumer prices (HICP) = 100 in 2006 (2007 survey refers to 2006 incomes)
Source: For expenditure for social protection benefits ESSPROS; for social inclusion EU-SILC.

Table C.4: **Structural policy and business environment indicators**

Performance indicators	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**
Labour productivity (real, per person employed, y-o-y)						
Labour productivity in industry	-5.11	5.74	3.26	1.96	0.96	1.34
Labour productivity in construction	-6.92	-5.52	-2.04	-1.21	-0.71	-2.51
Labour productivity in market services	2.31	0.61	1.36	-0.91	0.77	-0.89
Unit labour costs (ULC) (whole economy, y-o-y)						
ULC in industry	8.68	-5.43	0.23	2.55	2.17	1.24
ULC in construction	13.26	3.95	4.29	4.71	3.86	2.86
ULC in market services	2.35	0.88	1.24	4.26	2.97	3.52
Business environment	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**
Time needed to enforce contracts(1) (days)	397	397	397	397	397	397
Time needed to start a business(1) (days)	25.0	25.0	25.0	25.0	25.0	25.0
Outcome of applications by SMEs for bank loans(2)	0.52	0.23	0.24	0.23	0.35	0.41
Research and innovation	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**
R&D intensity	2.61	2.74	2.68	2.89	2.96	2.99
Total public expenditure on education as % of GDP, for all levels of education combined	5.98	5.91	5.80	5.56	na	na
Number of science & technology people employed as % of total employment	37	37	38	39	41	46
Population having completed tertiary education(3)	16	16	16	17	18	27
Young people with upper secondary level education(4)	86	86	85	86	87	90
Trade balance of high technology products as % of GDP	-0.15	-0.10	-0.03	0.13	0.19	0.50
Product and service markets and competition				**2003**	**2008**	**2013**
OECD product market regulation (PMR)(5), overall				1.61	1.37	1.19
OECD PMR(5), retail				3.50	3.30	2.40
OECD PMR(5), professional services				3.21	3.08	2.71
OECD PMR(5), network industries(6)				2.47	1.84	1.55

(1) The methodologies, including the assumptions, for this indicator are shown in detail here: http://www.doingbusiness.org/methodology.
(2) Average of the answer to question Q7B_a. "[Bank loan]: If you applied and tried to negotiate for this type of financing over the past six months, what was the outcome?". Answers were codified as follows: zero if received everything, one if received most of it, two if only received a limited part of it, three if refused or rejected and treated as missing values if the application is still pending or don't know.
(3) Percentage population aged 15-64 having completed tertiary education.
(4) Percentage population aged 20-24 having attained at least upper secondary education.
(5) Index: 0 = not regulated; 6 = most regulated. The methodologies of the OECD product market regulation indicators are shown in detail here: http://www.oecd.org/competition/reform/indicatorsofproductmarketregulationhomepage.htm
(6) Aggregate OECD indicators of regulation in energy, transport and communications (ETCR).
Source: "European Commission; World Bank — Doing Business (for enforcing contracts and time to start a business); OECD (for the product market regulation indicators); SAFE (for outcome of SMEs' applications for bank loans)."

Table C.5: **Green growth**

Green growth performance		2009	2010	2011	2012	2013	2014
Macroeconomic							
Energy intensity	kgoe / €	0.13	0.13	0.12	0.12	0.12	-
Carbon intensity	kg / €	0.30	0.31	0.30	0.29	0.28	-
Resource intensity (reciprocal of resource productivity)	kg / €	0.68	0.66	0.68	0.66	0.65	0.64
Waste intensity	kg / €	-	0.13	-	0.12	-	-
Energy balance of trade	% GDP	-2.4	-2.9	-3.7	-3.9	-3.5	-3.0
Weighting of energy in HICP	%	7.79	7.86	8.89	9.09	9.41	9.75
Difference between energy price change and inflation	%	-2.8	1.4	2.2	1.1	-0.1	-1.8
Real unit of energy cost	% of value added	15.1	16.3	17.5	-	-	-
Ratio of labour taxes to environmental taxes	ratio	9.7	9.8	9.4	9.7	10.0	10.1
Environmental taxes	% GDP	2.4	2.4	2.5	2.5	2.4	2.5
Sectoral							
Industry energy intensity	kgoe / €	0.17	0.17	0.16	0.15	0.15	-
Real unit energy cost for manufacturing industry	% of value added	18.1	21.2	23.5	-	-	-
Share of energy-intensive industries in the economy	% GDP	12.40	10.53	11.44	11.46	10.57	11.72
Electricity prices for medium-sized industrial users	€ / kWh	0.12	0.11	0.11	0.11	0.11	0.11
Gas prices for medium-sized industrial users	€ / kWh	0.03	0.04	0.04	0.04	0.04	0.04
Public R&D for energy	% GDP	0.01	0.01	0.01	0.01	0.02	0.02
Public R&D for environment	% GDP	0.01	0.01	0.02	0.02	0.02	0.02
Municipal waste recycling rate	%	91.1	94.2	91.6	92.4	92.7	-
Share of GHG emissions covered by ETS*	%	34.1	36.4	36.9	35.4	37.5	36.8
Transport energy intensity	kgoe / €	0.66	0.68	0.65	0.65	0.67	-
Transport carbon intensity	kg / €	1.69	1.75	1.65	1.65	1.73	-
Security of energy supply							
Energy import dependency	%	65.1	62.4	70.0	63.6	62.3	-
Aggregated supplier concentration index	HHI	29.7	28.8	33.5	40.3	24.8	-
Diversification of energy mix	HHI	0.28	0.28	0.26	0.27	0.27	-

Country-specific notes:
General explanation of the table items:
All macro intensity indicators are expressed as a ratio of a physical quantity to GDP (in 2005 prices)
Energy intensity: gross inland energy consumption (in kgoe) divided by GDP (in EUR)
Carbon intensity: greenhouse gas emissions (in kg CO2 equivalents) divided by GDP (in EUR)
Resource intensity: domestic material consumption (in kg) divided by GDP (in EUR)
Waste intensity: waste (in kg) divided by GDP (in EUR)
Energy balance of trade: the balance of energy exports and imports, expressed as % of GDP
Weighting of energy in HICP: the proportion of "energy" items in the consumption basket used for the construction of the HICP. Difference between energy price change and inflation: energy component of HICP, and total HICP inflation (annual % change)
Real unit energy cost: real energy costs as a percentage of total value added for the economy
Environmental taxes over labour taxes and GDP: from European Commission's database, 'Taxation trends in the European Union'
Industry energy intensity: final energy consumption of industry (in kgoe) divided by gross value added of industry (in 2005 EUR)
Real unit energy costs for manufacturing industry: real costs as a percentage of value added for manufacturing sectors
Share of energy-intensive industries in the economy: share of gross value added of the energy-intensive industries in GDP
Electricity and gas prices for medium-sized industrial users: consumption band 500–20 00MWh and 10 000–100 000 GJ; figures excl. VAT.
Municipal waste recycling rate: ratio of recycled municipal waste to total municipal waste
Public R&D for energy or for the environment: government spending on R&D (GBAORD) for these categories as % of GDP
Proportion of greenhouse gas (GHG) emissions covered by EU Emission Trading System (ETS): based on greenhouse gas emissions
(excl land use, land use change and forestry) as reported by Member States to the European Environment Agency)
Transport energy intensity: final energy consumption of transport activity (kgoe) divided by transport industry gross value added (in 2005 EUR)
Transport carbon intensity: greenhouse gas emissions in transport activity divided by gross value added of the transport sector. Energy import dependency: net energy imports divided by gross inland energy consumption incl. consumption of international bunker fuels
Aggregated supplier concentration index: covers oil, gas and coal. Smaller values indicate larger diversification and hence lower risk.
Diversification of the energy mix: Herfindahl index over natural gas, total petrol products, nuclear heat, renewable energies and solid fuels; * European Commission and European Environment Agency
Source: European Commission (Eurostat) unless indicated otherwise