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Reforms to reignite Austria's faltering growth

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Fire up the economy: a tram speeds through Vienna, where business leaders call for swift changes to fiscal policy

Over the past six years, Europe's economies have faced their fair share of difficulties. But while many have stumbled, Austria has emerged from the storms remarkably well.

The Alpine nation has registered economic growth each year since 2009, and quality of life is high. Social cohesion is strong and inequality low. Cosmopolitan Vienna is regularly ranked as one of the world's best places to live.

Among Austria's EU peers, only Germany boasts lower unemployment, and only Luxembourg higher output per head. As other countries struggle to restore economic competitiveness, Austria's export-orientated economy is poised to post a current account surplus for the 13th successive year.

Much of this success is due to the Mittelstand companies, the backbone of Austria's economy. The diversity of these myriad small and medium-sized groups is a source of great stability. And although they may lack the scale of the multinationals in neighbouring Switzerland, they have carved out lucrative niches in a range of global markets.

A decade after the EU welcomed 10 new members, mainly from central and eastern Europe, nimble Austrian companies have established themselves throughout the region. In return, hundreds of foreign groups have chosen Austria as the location for their regional headquarters.

"Our function as a hub for central, southeastern, and eastern Europe is a big reason foreign companies choose to base themselves here," says Reinhold Mitterlehner, Austria's vice-chancellor and minister for science, research and the economy.

Over the past year, however, Austria's ties to central and eastern Europe, which date back to the days of the Habsburg empire, have been less happy. The crisis in Ukraine and tit-for-tat sanctions between the west and Russia have put a dampener on business activity.

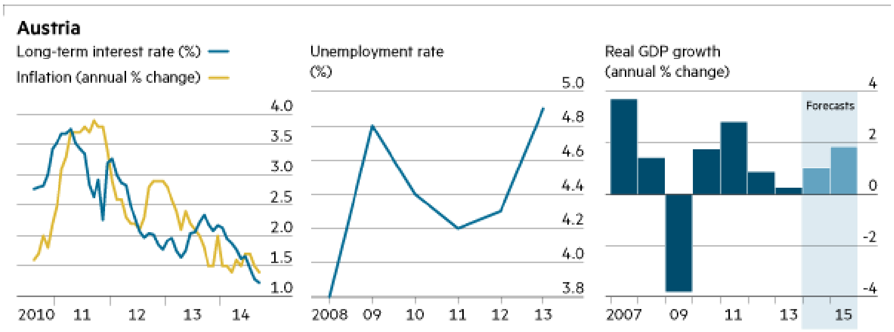
"The problem for Austria at the moment is that it is a small, relatively open economy, and so can't avoid what is happening around it," says Richard Grieveson, an analyst at the Economist Intelligence Unit. "And the external situation has deteriorated a lot."

While individual companies may be hit hard, the overall impact on Austria's exporters is likely to be manageable. Russia is the destination for just 2.8 per cent of goods exports, and the Austrian central bank (OeNB) says the EU sanctions on Russia will cost Austrian groups a maximum of €478m this year.

Of greater concern is the impact on the banks. Between them, Bank Austria and Raiffeisen Bank International – Austria's second and third-largest banks by assets – have a gross exposure of €36.2bn to Russia and €6.3bn to Ukraine.

Although the Russian market has held up relatively well, the conflict in Ukraine is one reason why Raiffeisen warns that it faces a loss of up to €500m this year.

"The geopolitical situation is a big worry," says Josef Christl, a consultant and former executive director of the OeNB. "Things look a bit calmer [now] but could easily flare up again. If they do, that could mean further writedowns, particularly for Raiffeisen, as Russia is by far their most important market."



Beyond such immediate concerns, several longer-term challenges are looming – and have recently been thrown into sharper relief by a deterioration in several economic indicators. Growth projections have been cut; unemployment, while low, is ticking upwards; and the cost of winding down Hypo Alpe Adria, a failed regional bank, will help push Austrian public debt to around 87 per cent of GDP.

The most pressing need, say business leaders, is to reform Austria's tax system. Not only is the tax take – at 45.3 per cent of GDP – high, steep social security and pension costs also mean the burden on labour is disproportionately heavy, and a drag on Austria's otherwise strong competitiveness.

"As a first step, we should set ourselves the goal of reducing the tax take to 40 per cent of GDP by 2020," says Wolfgang Eder, chief executive of the steel group Voestalpine. "In the longer term – in my opinion by 2030 – we should consider orienting ourselves by the 34 per cent Switzerland manages."

Austria's ruling coalition of the centre-left Social Democrats and centre-right People's Party, said in September that it was planning an income tax reduction of €5bn a year. However, it has yet to decide how the cuts will be financed. And as things stand, the reform seems unlikely to reduce non-wage labour costs, or reform the increasingly expensive pension system, one reason for Austria's high tax take.

The second big concern for business is education. Although Austria's tradition of apprenticeships, where young people work and study at the same time, has helped create a highly skilled labour force, reforms are needed in other parts of the education system.

"We have excellent engineers in Austria, but we have noticed that the level has been falling among the 14-year-olds we take on as apprentices," says Franz Struzl, chief executive of RHI, the maker of fireproof products. "That is something Austria needs to work on."

A third need is greater support for the capital markets. Vienna's stock exchange received a welcome boost this year when the aviation parts supplier FACC launched a €194m initial public offering, the first in Austria since 2011. However, activity remains muted in comparison to the days before the financial crisis.

One difficulty for the exchange is that, as elsewhere in Europe, small and medium-sized groups tend to rely on banks rather than capital markets for finance.

As lenders across the continent are hit by tougher capital requirements, there ought to be an opportunity for other providers of funding. But recently, policy makers have done little to encourage this: to the dismay of bankers, the country is one of 11 EU states toying with the idea of introducing a financial transactions tax.

"We need to stop talking about the FTT," says Karl Sevelda, chief executive of Raiffeisen. "It will just drive transactions out of Austria."

In recent years, the coalition's lack of progress in pushing through reforms has spurred support for a growing array of opposition parties.

Last year's general election saw two new groupings – the liberal party Neos, and another set up by the billionaire tycoon, Frank Stronach – enter parliament. The Greens are now part of six of Austria's nine regional governments. The most successful opposition group, however, is the far-right Freedom party (FPÖ), which currently enjoys more support than any other party, according to a string of recent opinion polls.

The upshot of these political shifts, says Anton Pelinka, professor of political science at the central European University, is that the coalition of the Social Democrats and the People's Party could finally lose its overall majority at the next general election, due in 2018.

"Voters increasingly prefer groups that are incapable of combining . . . to form a government," he says. "In economic terms, Austria is doing pretty well in comparison with the rest of Europe. But in political terms, it is entering a period of uncertainty."