FISCUL RULES COMPLIANCE REPORT 2019–2021 FOR AUSTRIA (MAY 2020) – SUMMARY AND RECOMMENDATIONS

Assessment of the fiscal situation from 2020 to 2021

The drafting period for the Fiscal Advisory Council's "Fiscal rules compliance report for 2019 to 2021" was characterized by a steady flow of COVID-19-related legislation – from the initial launch in mid-March 2020 of comprehensive support measures for the Austrian economy to the adoption of the 21st piece of such legislation in mid-May. With numerous downstream decrees and regulations to be taken into account as well, this forecast remained a challenging moving target. In the context of a global recession, the social and economic lockdown engineered with these measures sent the Austrian economy into a massive downturn. WIFO's current economic outlook for Austria, on which this forecast is based, expects real economic output to shrink by 5.2% in 2020. Given the unprecedented framework conditions under which this forecast was compiled, a high degree of uncertainty prevails about the potential fiscal effects of the government's COVID-19 response and the performance of the Austrian economy in the years ahead.

The COVID-19 support package adopted by the central government includes an immediate aid program, a coronavirus relief fund, COVID-19 short-time work arrangements and flexible payment options for tax and advance tax liabilities. Including guarantees, EUR 38 billion have been earmarked for these relief measures. However, some of these measures are not going to affect the fiscal balance (based on ESA definitions) at all or in full. The Fiscal Advisory Council's forecast expects the COVID-19 measures to raise the deficit for 2020 by EUR 26.8 billion, above all on account of higher discretionary spending. The concomitant economic setback is projected to raise the deficit by another EUR 10.4 billion, mainly on account of revenue losses. We thus arrive at a total health crisis effect of EUR 37.2 billion on the fiscal balance.

Measured as a percentage of GDP, we expect Austria's fiscal balance to deteriorate to –9.4% of GDP in 2020. Higher spending – including a surge of subsidies (+4.6% of GDP) and social benefits in cash (+1.8% of GDP) – is expected to drive up the expenditure ratio by 9.5% to 57.7%. Lower revenues are expected to depress the revenue ratio by 0.7% to 48.3%. The key determinant will be the sharp decline of current taxes on income, wealth, etc. (–1.1% of GDP). For 2021, we project a fiscal balance of –3.0% of GDP, based on the following considerations: Revenue growth will exceed GDP growth despite the implementation of the first leg of the 2020 tax reform, driven among other things by the exit from short-time working (which reduces wage income tax revenue in 2020) and flexible payment options for advance tax liabilities (which generate extra revenue in 2021). The revenue ratio is expected to increase slightly by 0.1% to 48.4%. At the same time, spending is projected to decline by as much as 7.1% of GDP in 2021, primarily due to the phaseout of the COVID-19-related measures. Thus, we expect Austria's debt ratio for 2020 to jump by 12.0 percentage points to 82.4% of GDP, above all on account of the high primary deficit (8% of GDP). For 2021, a primary deficit of 1.8% notwithstanding, we expect the debt ratio to decline slightly (by 0.6 percentage points) to 81.8%, driven by rebounding GDP growth in particular.

Substantial spending increases and revenue losses due to COVID-19 support package and massive economic setback

The projected decline of general government revenues in 2020 (–EUR 10.4 billion or –5.3% against 2019) is attributable virtually in full to the effects of the COVID-19 pandemic. Including the revenues that might

have been generated with the economy growing at a real rate of 1.2% in 2020, as still anticipated in late 2019, the economic fallout of the coronavirus health crisis produces a revenue shortfall of EUR 9.5 billion in 2020. The revenue losses attributable to coronavirus-related discretionary measures (including flexible payment options for advance tax liabilities, lower beverage sales taxes for restaurants and a lower intake of wage income tax given short-time working) are expected to run to EUR 6.0 billion. In sum, we thus arrive at a decline of public revenues by EUR 15.5 billion attributable to coronavirus. Lower wage income tax revenues also imply significantly lower municipal tax revenues. The convergence of the cyclical slowdown with lower VAT rates for nonalcoholic beverages for the second half of 2020 and unrecoverable tax deferrals leads to considerably lower revenues from the VAT regime, mineral oil tax and motor vehicle registration tax. The resulting loss of revenues adds up to 4.1% for indirect taxes and to as much as 12.1% for direct taxes. In particular, we expect that the flexible payment options for advance tax liabilities will reduce personal income tax revenues by EUR 1.5 billion and corporate income tax revenues by EUR 3.5 billion in 2020. In contrast, the decline in wage income tax revenues and social security contributions projected for 2020 will be limited. This is above all attributable to the stabilizing effect of the short-time work arrangements, in the absence of which there would have been much higher layoffs and a sharper decline in wage income tax revenues. With WIFO's latest economic outlook anticipating an economic recovery for 2021, general government revenues stand to increase substantially in 2021, and will, according to our forecast, even slightly exceed the pre-crisis level of 2019 but fall visibly short of the values expected for 2021 in 2019. We also anticipate the exit from flexible payment options for advance tax liabilities to generate higher revenues in 2021. On balance, public revenues will increase by EUR 8.1 billion or 4.4%.

Based on current information, we expect general government spending to increase by as much as EUR 28.4 billion or 14.8% in 2020 against 2019. The discretionary measures adopted to offset the medical and socio-economic impact of the coronavirus crisis account for EUR 20.8 billion thereof. The biggest relief measures are the COVID-19 short-time work arrangements to prevent layoffs, which we expect to cost EUR 8.0 billion, and the coronavirus relief fund set up to address firms' short-term liquidity needs, with EUR 7.2 billion earmarked for fixed cost subsidies. Additional coronavirus-related spending refers to income support from a hardship fund for micro businesses, self-employed individuals and professionals; subsidies for NGOs; and dedicated relief funds, such as relief funds for high-risk groups and parents on special leave of absence. Furthermore, we expect substantial increases in health care spending, for instance for purchases of medical products and protective gear. The sharp increase in unemployment translates into major spending increases for unemployment benefits, means-tested benefits and social assistance. The spending projections for 2021 are driven by the lifting of the special discretionary measures adopted for 2020, a recovery of the labor market and moderate pension increases compared with previous years. As in 2020, interest expenditure on outstanding public debt will contract markedly. On balance, general government spending is expected to decline by EUR 15.7 billion or 7.1% in 2021.

Deficits substantially higher than expected by the Ministry of Finance under the latest stability programme update

Given the COVID-19 pandemic and the related uncertainty, the time series included in the latest update of Austria's stability programme do not go beyond 2021. In the update, Austria's fiscal balance is expected to deteriorate to –8% of GDP in 2020, and to improve by 6.1 percentage points to –1.9% of GDP in 2021. The improvement anticipated for 2021 reflects the easing of economic conditions projected for the second half of 2020 and beyond in WIFO's economic outlook for Austria. This means that the Fiscal Advisory Council expects Austria's fiscal deficit (Maastricht definition) to exceed the deficits projected by the government under the latest stability programme update by 1.4% of GDP in 2020, and by 1.1% of GDP in 2021, subject to the following considerations. Regarding revenue projections, we are considerably more pessimistic than the stability programme about the development of current taxes on income,

wealth, etc., social security contributions and income from production activity. Moreover, we arrive at a substantially higher impact of general government spending on the 2020 budget deficit than the stability programme, which is attributable to some extent to the fact that our figures are based on more current information. For instance, we were able to consider the subsidies for NGOs, which were set at EUR 0.7 billion in mid-May. Finally, we anticipate COVID-19 short-time working to cost an extra EUR 1 billion.

Austria failing to comply with several EU fiscal rules in 2019–2021 period due to COVID-19 pandemic

Austria's benchmark for a sound fiscal policy is a medium-term budgetary objective (MTO) of –0.5% of GDP for the structural budget deficit. Taking into account estimates of potential output, which we do not consider a sound basis for interpreting Austria's fiscal stance given the crisis-related inadequacy of data, the Fiscal Advisory Council's forecast for 2019 would imply a breach of the MTO and a "significant" breach of the expenditure rule (average deviation during 2018 and 2019). While this would imply corresponding action by the European Commission, the Commission acts only on the basis of its own figures, and its findings are different. The European Commission's spring 2020 economic forecast, which was based on a modified estimation methodology for potential output, found Austria in compliance with its MTO requirement. Therefore, the breach of the expenditure rule was not considered "significant," which is why the early warning mechanism ("significant deviation procedure") was not triggered. Deviations from the structural budget requirements in 2020 and 2021 will not be sanctioned following activation of the general escape clause of the Stability and Growth Pact in view of the COVID-19 pandemic.

Table 1: EU fiscal rules as applied to Austria

	European Commission estimate			Fiscal Advisory Council estimate			Federal Ministry of Finance estimate		
Staat insgesamt	**2019**	**2020**	**2021**	**2019**	**2020**	**2021**	**2019**	**2020**	**2021**
Maastricht deficit of no more than 3% of GDP	✓	⊗	✓	✓	⊗	⊗	✓	⊗	✓
MTO of no more than -0,5% of GDP[1]	✓	general escape clause		⊗	general escape clause		⊗	general escape clause	
Government expenditure growth	⊗ [2]			⊗			⊗		
Reduction of debt ratio	✓	⊗	✓	✓	⊗	⊗	✓	⊗	✓
Austrian general government fiscal indicators (% of GDP)									
Budget balance (Maastricht definition)	0.7	-6.1	-1.9	0.7	-9.4	-3.0	0.7	-8.0	-1.9
Structural budget balance[1]	-0.3	general escape clause		-0.8	general escape clause		-0.8	general escape clause	
Total expenditure (nominal, adjusted, net of one-offs, change in %)	.			**3.8**			**3.7**		
Gross debt (year-end figures)	70.4	78.8	75.8	70.4	82.4	81.8	70.4	81.4	79.3

Legend: ✓ ... compliant with fiscal rule, ⊗ ... not compliant with fiscal rule, ⊗ ... not compliant with fiscal rule + significant deviation[3]

1) 2019 incl. eligible deviations under unusual event clause, e.g. costs related to refugees. Red figures apply under the regular approach for estimating potential output rather than the modified methodology used temporarily by the European Commission.

2) A deviation from the expenditure benchmark is not considered significant if the Member State concerned has overachieved the MTO.

3) A deviation is deemed significant if the structural deficit deviates at least by 0.5% of GDP from the structural adjustment path or the MTO within one year or cumulated over two years.

Source: Fiscal Advisory Council (Forecast, May 2020), European Commission (Forecast, May 2020), Ministry of Finance (Stability Programme 2020), WIFO (Forecast, March 2020), authors' calculations.

While Austria stayed clearly below the deficit reference value of 3% of GDP in 2019, the COVID-19 response triggers a significant breach of the deficit criterion in 2020. The clear breach of the deficit rule in 2020 prompted the European Commission to issue a report under Article 126 (3) TFEU with a view to establishing the existence of an excessive deficit and concluding whether or not to open an excessive deficit procedure. The European Commission concluded that such a procedure was not warranted given the unusual event of the COVID-19 pandemic and the related huge uncertainty about the ensuing macroeconomic and fiscal effects.

According to our calculations, Austria fails to meet the requirements of the EU debt rule also in 2020 and 2021. However, using a modified estimation methodology for potential output, the European Commission again concludes that Austria will have recovered sufficiently by 2021 to meet the required cyclically adjusted debt ratio and thus comply with the debt rule.

Under national fiscal rules: no sanctions for 2019, general escape clause activated for 2020 and 2021

The fiscal balances for 2019 notified by the local and regional governments in March 2020 add up to a surplus of EUR 0.7 billion (regional chambers included), thus bolstering the central government's surplus (EUR 2.0 billion). This resulted in a clear improvement of the balances on the corresponding control accounts – the monitoring tool for establishing the amounts by which the realized structural budget balances of the central, regional and local governments deviate from their annual targets agreed under the Austrian Stability Pact (ASP 2012). While the notified figures may deteriorate for Burgenland (at the regional level) and for Vorarlberg (at the municipal level) given higher deficits, no sanctions would be forthcoming on the basis of current data. However, this is a preliminary assessment for 2019, which may change significantly, depending on the potential output estimation methodology to be used in the fall of 2020 for establishing the structural fiscal balances and the control account balances.

2020 and 2021 will be characterized by the activation of the general escape clause at the national level under Article 11 ASP 2012, under which escape clauses activated at the EU level also apply under national rules. In other words, the structural budget rules (control account-based monitoring, expenditure rule) are overruled by the general escape clause applicable at the EU level, which allows for a concerted orderly deviation from the regular fiscal requirements. In line with practice at the EU level, we will not make an ex ante evaluation of compliance with the national fiscal rules for 2020 and 2021 for the time being. Likewise, we are not going to offer an ex ante evaluation of the debt paths of the different levels of government, as the data underlying medium-term budget planning at the local and regional level in the fall of 2019 reflect the conditions prevailing before the COVID-19 pandemic started to strain health budgets and the economy.

Recommendations of the Fiscal Advisory Council on Austria's budget policy for 2020

Allow debt ratio to rise in 2020; seek to safeguard sustainable public finances through structural reforms

Background: Austria considerably reduced its debt ratio following the financial crisis thanks to combining stability-oriented fiscal policymaking with sustained efforts to resolve nationalized banks (immigon portfolioabbau ag, HETA and KA-Finanz AG). Thus, the debt ratio sank from 84.9% of GDP in 2015 to 70.4% of GDP in 2019. In 2020, the economic and social lockdown engineered by the government to contain the COVID-19 pandemic amid a global recession sent the Austrian economy into a massive downturn. In its current economic outlook for Austria, WIFO expects real economic output to decline by 5.2% in 2020. In light of this, we expect Austria's debt ratio for 2020 to jump by 12.0 percentage points to 82.4% of GDP, above all driven by a high primary deficit (8% of GDP) and the decline in GDP. For 2021, we expect the debt ratio to inch down by 0.6 percentage points to 81.8% despite a primary deficit of 1.8%, thanks to rebounding output growth in particular.

Recommendations:

- Seeking to actively reduce the debt ratio with short-term measures to raise revenues or cut expenditure appears inadequate at present and ought to be avoided with a view to allowing automatic stabilizers to operate in full. The sharp increase of the debt ratio in 2020 was triggered by one-off discretionary measures as well as the temporary decline of economic output, which went hand in hand with a surge in public spending and a revenue setback. Over the medium term, the fallout from the COVID-19 pandemic is unlikely to affect fiscal flow measures, and the debt ratio should be driven downward automatically to sustainable levels through the convergence of rebounding GDP growth, low sovereign bond yields and the return of revenue and expenditure levels to their medium-term growth paths.

- Given the surge of Austria's debt level and the risk of a new spike of COVID-19 infection cases and other existing risks, efforts will be required to start building up new fiscal risk buffers over the medium to long term. Thus, it would be important to swiftly implement structural reforms that have been advocated for years and decades, including above all measures to reform government and the system of taxes and subsidies, measures to redesign and sustainably finance the system of long-term care, and efforts to strengthen the sustainability of Austria's pension system. Swift action would be required to secure the necessary funding for adequate risk provisioning. The need to generate fiscal leeway apart, these structural reforms would also create important momentum to stimulate long-term potential output growth and increase the resilience of the domestic economy.

Focus policy measures on strengthening the labor market given its special fiscal and social relevance

Background: Roughly half of general government revenue is driven by changes in the compensation of labor, which affect above all wage income tax and social security contributions but also municipal taxes. The fiscal impact of a range of macroeconomic shocks has been driven home by assessments made by the Fiscal Advisory Council. Supply-side shocks were found to have a visibly lower impact on the deficit ratio than demand-side shocks, and the difference is almost exclusively attributable to the fact that labor market conditions remain more stable in a supply-side shock.

Recommendations:

- Given the high fiscal relevance of labor market developments, the Fiscal Advisory Council welcomes the measures adopted by the government to implement, and later extend, short-time work arrangements.

- Measures to strengthen corporate liquidity, capitalization and aggregate demand are important for keeping domestic businesses afloat. In this vein, it would be important to make tax deferrals an option beyond the current deadline of September 2020, similar to the prolongation of the temporary waiver of social security contributions.

- The measures adopted in response to the crisis, which the Fiscal Advisory Council welcomes, should be lifted when the crisis is over, subject to an orderly exit strategy.

- The design of the measures must be transparent, as must be the take-up of these measures, to allow for well-informed decisions about future action and the need for such action.

- Immediate action is also required to empower the Public Employment Service Austria to step up job referral and job search assistance services and qualification measures, to prevent deskilling

and production potential limitations from rising. In this context, particular attention ought to be paid to measures supporting the youth and long-term unemployed.

Go for "green" investments to stimulate the economy and cut CO_2 emissions

Background: Even though the COVID-19 pandemic will bring down greenhouse gas emissions over the short term, Austria still fails to meet the internationally agreed climate goals on a structural level. According to the burden-sharing goals defined in the regulatory EU framework, Austria is required to cut back its emissions by 28% until 2030 in those sectors of the economy which are not covered by the emissions trading system.

A number of scenarios identified by the Environment Agency Austria show that Austria is off benchmark even when factoring in offsetting measures. When failing to meet the cap on emissions, Austria will face a significant budgetary burden, as it will have to buy emission allowances from other Member States to offset its undercoverage. In the absence of an institutional framework for purchasing such allowances, the potential costs remain subject to a high degree of uncertainty – but a number of costing exercises imply that these costs may add up to several billions of euro.

The national energy and climate plan adopted by the Austrian government envisages close to 300 measures to secure compliance with the climate objectives. According to this plan, these measures will require substantial investment efforts as well as measures for greening the tax, funding and incentive system.

Recommendations:

- The Fiscal Advisory Council calls for rapid implementation of measures aimed at cutting greenhouse gas emissions, to make sure Austria will meet its national and international climate goals.

- To reap the highest possible macroeconomic dividends, it would make sense to step up public investments above all in areas that promise to generate "twin dividends." Such measures include above all "green" investments (including rapid implementation of the Austrian Federal Railways' framework investment program, programs to improve local and regional public transportation services in metropolitan areas, renovation projects to raise thermal energy efficiency, programs to expand e-mobility and bicycle infrastructure) which have the additional benefit of stimulating the economy, improving the regional diversification of investment, reinforce Austria's growth potential in a sustained manner and speed up the greening of the economy.

- The instrument of choice would be a balanced mix of tools (tax system, emissions trading, steering measures) with a view to setting incentives for greening measures. To this end, it is important to develop a tight timeline and implement measures consistently.

Reduce control account deficits in line with the business cycle and identify the implications of the general escape clause

Background: The Fiscal Advisory Council has the legal mandate to issue recommendations on activating, extending or discontinuing the "correction mechanism" under the Austrian Stability Pact. This relates to the evaluation of the control account balances, which are kept to record deviations between the realized structural budget balances at the different levels of government and the corresponding annual target values. If control account deficits breach certain limits (rule-specific limits, thresholds), they must be reduced in line with specified criteria. The Fiscal Advisory Council's preliminary assessment for 2019 indicates a potential requirement for Vorarlberg's municipal control account deficits to be cut "without

undue delay" in 2021 and beyond. This requirement would create a special challenge under the current precarious cyclical conditions.

With the general escape clause having been activated at the EU level for the first time, national governments are navigating uncharted territory that allows considerable scope for operationalization. After all, there is no EU benchmark against which to measure implementation at the national level. In late summer 2020, a working group is going to discuss the practical implementation of the general escape clause under the Austrian Stability Pact and develop draft decisions for the Austrian Coordination Committee responsible for deliberating the intergovernmental budgetary framework, which is due to convene in the fall.

Recommendations:

- To avoid a procyclical effect when reducing control account deficits, it is generally important to take relevant measures with the state of the economic cycle in mind. Depending on the extent of the breach, it might be sensible to differentiate in terms of the time horizon granted for deficit correction. Such an adjustment would take into account both the current difficult economic conditions and the modified implementation of the fiscal rules given the activation of the general escape clause.

- To apply the national fiscal rules under the general escape clause consistently, it would be necessary for all parties to the Austrian Stability Pact as well as the monitoring institutions (Statistics Austria, Court of Audit and Fiscal Advisory Council) to arrive at a common understanding of how to proceed. In this respect, the following issues will have to be clarified and agreed upon:

    - Defining what the operationalization of the general escape clause at the EU level implies for the application of the clause under the Austrian Stability Pact,
    - identifying all national and regional COVID-19 measures and their fiscal effects, based on a consistent stocktaking and costing approach,
    - producing a final estimate of potential output, possibly using the European Commission's modified methodology, and
    - updating medium-term budgetary plans based on agreed macro scenarios and revenue expectations.