FISCAL SUSTAINABILITY REPORT FOR AUSTRIA 2021 – MAIN RESULTS AND CONCLUSIONS (SEPTEMBER 2021)

Ensuring sustainable public finances is a precondition for achieving economic policy goals. Hence, the present report provides the Austrian Fiscal Advisory Council's assessment of the long-run sustainability of the public finances in Austria, based on the Council's own projections until 2070.

Our analysis shows that a rapid return to the favorable fiscal position Austria had achieved before the outbreak of the COVID-19 pandemic would generate room for maneuver in the short to medium term. In the long run, however, rising demographics-related spending constitutes a risk to fiscal sustainability. Policymakers ought to use the room for near-term structural reforms and growth-promoting investment, and they ought to act while the climate is benevolent.

For the purpose of this report, we assessed sustainability primarily in terms of demographic sustainability. Complementary assessments of ecological factors such as climate risks would underline the urgency of spending more to address climate change and protect our environment. Such ecological assessments would need to take into consideration a broad range of factors: potential macroeconomic knock-on effects of changes in capital stocks and productivity growth, fiscal policy implications of public investment needs and private investment support, and potential penalties for noncompliance with mandatory climate objectives.

Increasingly larger budget fiscal gap to emerge in the long term, which may be addressed with short- to medium-term action

The Fiscal Advisory Council's projections are based on a new dedicated model, using assumptions on population aging, technological progress and interest rate levels, etc. Moreover, the projections are performed under a no-policy-change assumption (meaning that any economic policy measures included in our projections have already been approved).

The COVID-19 pandemic hit Austria at a time when public finances were broadly balanced. Thus, policymakers were in a position to take strong fiscal action and allow debt levels to rise sharply without triggering a negative response on international financial markets that would have affected Austria's ratings. Looking ahead, we see a need for swift action to rebuild resilience, to make sure Austria would be equally well equipped to withstand future crises.

In the short run, and assuming no new fiscal measures, the economic upswing and the lifting of the pandemic-related fiscal measures will initially cause the debt ratio to go down, reflecting the return of domestic output growth and of Austria's primary fiscal balance to pre-pandemic levels. According to our projections, the good performance of the Austrian economy and the assumed decline of the debt ratio – i.e. a moderate decline toward 60% of GDP, the upper reference value under the EU debt rule – create a window of opportunity for undertaking additional fiscal measures in the near term. The scope for measures is, however, narrowing over time; down the line, the positive primary balance will turn into a negative one. Thus, great caution is needed so as not to rush ahead and use up the scope for near-term action through measures that would level up expenditure and level down revenue on a permanent basis, as measures with a permanent effect will increase the fiscal gap that is building up in the long term.

In the medium term, the debt ratio will continue to go down due to a substantial negative interest-growth differential until the late 2030s. At the same time, spending will go up in line with demographic change. According to Statistics Austria's latest population forecast, the number of people 65 or older in the overall population will rise from currently 19% to 30% until 2070. By and by, the steady increase in demographics-related spending will offset the effect arising from the negative interest-growth differential,

causing the debt level to rise again. The medium-term sustainability indicator (S1) as defined by the European Commission likewise implies some short- to medium-term fiscal scope; again based on a no-policy-change assumption, the debt ratio could be brought down to 60% by 2045 without additional fiscal consolidation measures.

Starting from the 2050s, our assessment highlights a need for consolidation measures in order to keep the debt ratio from rising, without prejudice to any action that may be required to address climate change. Our assessment points to an increasingly large fiscal gap, driven by the rise in demographics-related spending, yet cushioned by the interest-growth differential, which remains negative even in the long term. Over time, the fiscal gap will widen to 2.5% of GDP by 2070. In the absence of new economic policy measures, the debt ratio is forecast to reach 81.4% of GDP by 2070, accelerated by strong incremental annual increases toward the end of the forecasting horizon. The long-term sustainability indicator (S2) as defined by the European Commission also highlights the need for spending cuts or measures generating additional revenue on a permanent basis as a precondition for stabilizing the debt ratio in the long term.

It will take structural reforms, accompanied by investment to support growth, in order to offset the fiscal gap that is building up in the long term

Investment to support growth and accelerate technological progress (e.g. digital transformation) will contribute to narrowing the identified long-term fiscal gap. Potential public sector investment and/or support for private investment should also contribute to achieving Austria's objectives with regard to addressing climate change. At the same time, our scenario analysis implies that the long-term fiscal gap might decrease by about one-quarter, from 2.5% to 1.9% of GDP, if productivity gains were to increase significantly from 0.9% p. a. to 1.2% p. a. (under this scenario, GDP would be about 22% higher in 2070 than under the baseline scenario).

At any rate, structural reforms in demographics-sensitive areas (health care, long-term care and pensions), supported by growth-promoting investment, would be effective in offsetting the long-term fiscal gap. Structural reforms relate to the cost efficiency of systems and to strengthening the link between benefits and contributions.

Thus, one way to narrow the long-term fiscal gap effectively would be to lower the annual growth of health care spending by 0.3 percentage points to 3.8% (as a result of which health care spending would rise from 6.7% of GDP in 2019 to 8.2% of GDP in 2070, instead of 9.3% of GDP). This would reduce the budget deficit by 1.1% of GDP to 1.4% of GDP. The same budgetary effect, i.e. a decrease of the budget deficit to 1.4%, could be achieved by measures to gradually increase the expected effective retirement age from 62.5 to 64.5 years by 2070. This would mean that the number of years individuals spend in retirement over their lifetimes remains unchanged from 2033 onward.

In contrast, measures that do not generate spending cuts or revenue increases or drive up growth in the long term will cause the fiscal gap to widen, thus jeopardizing Austria's fiscal sustainability. For instance, additional pension increases totaling 0.4 percentage points p.a. (= average of the past four years) would widen the long-term fiscal gap by another 0.7% of GDP, to 3.3% instead of 2.5% of GDP. Thus, there is a case to be made for undertaking the structural reforms advocated repeatedly in the past (e.g. measures to reform the federal system, the grant framework or the social care system) in order to broaden the scope for necessary future spending or for tax cuts. Of course, such reforms require adequate lead time, e.g. for system migration, the protection of legitimate expectations and the like. An alternative to offsetting the fiscal gap through structural reforms and growth-promoting investment would be to raise taxes.

Austria's long-term fiscal position largely unaffected by the COVID-19 pandemic

The long-term forecast underlying this report is the first assessment for Austria to date which factors in the effects of the COVID-19 pandemic situation. Based on the assumption that all pandemic-related support measures will be lifted as envisaged, we expect Austria to broadly return to its pre-pandemic primary balance path, albeit against the backdrop of a markedly higher debt levels. As a result of the COVID-19 pandemic, the medium-term S1 indicator, which reflects reductions in debt levels, has deteriorated from −1.2 to −0.5. The long-term S2 indicator is essentially driven by the aging-related long-term deterioration of the primary balance rather than the higher debt ratio, since the rise in the debt ratio is offset by the negative interest-growth differential. Hence, S2 has remained more or less unchanged at a level of 2.5 despite the pandemic.

Outcomes sensitive to assumptions on population, productivity and interest rates but qualitatively robust with regard to the fiscal scope and the fiscal gap

Given uncertainty about the long-term development of key variables entering the forecast as assumptions, sensitivity analyses play an important role in the context of long-term forecasts. In particular, we find that the outcomes are sensitive to our assumptions on the population forecast, productivity growth and interest rate levels. The key finding of fiscal scope until at least 2040 but increasingly larger deficits by the mid-2050s at the latest is confirmed by all scenarios under review. The fiscal position will improve, both in the medium and the long term, in line with a permanent rise in net migration – assuming that migrants match the socioeconomic characteristics of the population at large on average. In contrast, the fiscal position will deteriorate in line with rising life expectancy. Higher productivity growth can decrease the long-term fiscal gaps, but it cannot offset the deficits completely. The relevance of interest rate levels becomes evident when we look at current interest payments on government debt (lowest payments relative to GDP since 1975 despite the third-highest debt ratio in 2020). Given the long-term structure of domestic government debt, interest rate changes impact average interest rates only with a significant lag. Another uncertainty factor is based on the assumption that the pandemic-related measures will be lifted almost across the board as envisaged. Retaining individual support measures, which lead to a permanent structural decline of the primary budget balance, would significantly limit the forecast medium-term fiscal scope and widen the long-term fiscal gap.

Demographics-related expenditure forecast to rise by 5.8% of GDP until 2070

We expect government expenditure to rise significantly until 2070 compared with 2019 pre-pandemic levels, mostly on account of demographic changes. About half of the demographics-driven increase in expenditure is attributable to higher health care costs (+2.8% of GDP). Interestingly, a significant portion of the rise in health care costs is due to legacy policy measures rather than being directly attributable to the impact of inflation, productivity gains or changes in the population structure. A better understanding of how past measures have contributed to driving up health care costs may help identify possible measures to contain the costs. The corresponding estimates from other Sustainability Reports (WIFO/Federal Ministry of Finance and European Commission),[1] which also point to a significant increase in health care spending, are more optimistic than we are in our forecast. Regarding pension costs, we forecast an increase by 1.2% of GDP by 2070, which is more optimistic than the WIFO/Federal Ministry of Finance forecast and matches the European Commission's latest projections. Long-term care exhibits the strongest rise compared to other areas, namely a rise in expenditure by 1.8% to 3.1% of GDP in 2070, which is broadly in line with the results obtained by the other Sustainability Reports. The declining

[1] The Austrian Institute of Economic Research (WIFO) regularly publishes long-term budget forecasts commissioned by the Federal Ministry of Finance (the most recent forecast was published in 2019). The European Commission's Ageing Report is published at three-year intervals. The latest update was released in early 2021. The European' Commission's Fiscal Sustainability Report, which builds on the Ageing Report, is due in the fall of 2021.

expenditure ratios for public administration and “other transfers” to households decrease overall expenditure growth (+4.2% of GDP by 2070) by 0.8% of GDP in 2070, respectively.

Government revenue ratio forecast to remain broadly unchanged, with a slight decline in the long term

Our assessment is based on the assumption that the pandemic-related measures will be lifted swiftly, and that revenues will normalize in the next couple of years. In the long term, the government revenue ratio (government revenues relative to GDP) is expected to develop much more steadily than the government expenditure ratio, given the close alignment between government revenues and output. The revenue ratio is forecast to fall short of 2019 levels by 0.2% of GDP in 2050; this gap will widen to 0.5% of GDP by 2070. The most striking change relates to pensioners’ income tax. In spite of the growing number of pensioners, tax revenue continues to decline in the long term due to tax progressivity and declining average pensions.

Primary balance forecast to remain positive until the late 2030s, before moving into increasingly negative territory

Subject to a no-policy-change assumption, we expect the lifting of COVID-19-related support measures to coincide with a broad return of the primary budget balance to pre-pandemic levels, i.e. to primary surpluses in the medium run. Our projections indicate that the surpluses will peak at 1.8% of GDP in 2025 and 2026. Thereafter, pressure from the demographics-related increase in expenditure is expected to cause the primary surpluses to turn into primary deficits in the late 2030s, which are forecast to grow to −2.6% of GDP until 2070. However, the room for fiscal maneuver will not slide into negative territory until a decade later. This lag is attributable to the persistently negative interest-growth differential, which significantly delays the sign change observed for the fiscal scope.

Interest payments relative to GDP forecast to go down further in the medium term but to visibly exceed current levels in the long term

Historically low interest rates continue to bring down interest payments to as little as 0.5% of GDP in the 2030s and 2040s. Anticipating today’s accommodative monetary policies to be unwound gradually in the long run and factoring in the associated rise in interest rates on government debt, we expect interest payments relative to GDP to go up again, ultimately to a ratio of 2.5% in 2070, despite the high share of medium- and long-term debt. This means that outlays for interest will significantly exceed the current level (1.4% of GDP), thus creating an extra burden on public finances.

Policy implications of indicators S1 and S2 limited so far

The persistently negative interest-growth differential over the entire forecasting horizon affects the need for adjustment measures and the timing of action, as implied by the S1 and S2 indicators, over time. As defined at present, S1 quantifies the amount of permanent fiscal adjustment that would be required five years ahead in order to ensure a debt ratio of 60% in 2044. A negative interest-growth differential causes the debt ratio to improve naturally over time. Ceteris paribus, this implies that the S1 indicator keeps improving as well. S2 quantifies the amount of permanent fiscal adjustment that would be required now in order to stabilize the debt ratio in the long term. While this indicator does not change over time in line with the debt ratio, policy implications derived from the indicator need to be interpreted with caution with regard to the timing of action. Given a negative interest-growth differential, the message of S2 in terms of policy implications is that there will be no need for additional consolidation measures. In other words, delays in the implementation of measures deemed necessary based on S2 would not increase the need for adjustment measures implied by the indicator. In this context, it will be important not to lose sight of other arguments against high debt levels. In particular, to build resilience in crisis, policy actions must provide for a safety margin to potential debt ratio thresholds to factor in the possibility of a nonlinear interest rate response to debt.

Accurate Fiscal Advisory Council OLG model provides value added for a comprehensive analysis of fiscal sustainability for Austria

Accurately modeling the Austrian economy with our overlapping-generations (OLG) model enables us to take into account national data and idiosyncracies, while the reports generated by the European Commission serve to provide for international comparability based on uniform exogenous assumptions. The accuracy of our OLG model allows us to iteratively capture the interaction between economic developments with government measures and subject outcomes to in-depth plausibility checks. This report, which contains the findings of the Fiscal Advisory Council's assessment of the long-run sustainability of public finances in Austria, thus adds an important complementary perspective to corresponding assessments.