FISKALRAT Austria

FISCAL RULES COMPLIANCE REPORT 2021–2026 FOR AUSTRIA (JUNE 2022) KEY RESULTS (EXECUTIVE SUMMARY) AND RECOMMENDATIONS

Assessment of Austria's fiscal situation from 2022 to 2026

The present fiscal forecast by the Austrian Fiscal Advisory Council was drawn up in an environment marked by enormous uncertainties regarding the macroeconomic and fiscal implications of the war in Ukraine as well as the future course of the COVID-19 pandemic. Factors such as the duration of the war, the tightening of sanctions against Russia and its allies, supply bottlenecks, rising prices and a possible embargo on Russian gas have a substantial impact on Austria's medium-term fiscal and debt path. Just like the future course of the pandemic, these factors are hard to capture, however. Moreover, our fiscal forecast must start out from a no-policy change assumption, which means that economic policy measures can only be factored in once they have been adopted. Substantial risks to the forecast of public revenue and expenditure thus arise, inter alia, from any economic policy action that may have to be taken to counteract the above factors.

As both information on geopolitical and health policy developments and more recent estimates of their macroeconomic effects are lacking at the current juncture, this fiscal forecast is based on the economic outlook published by the Austrian Institute of Economic Research (WIFO) in late March 2022, which in turn provides the basis for WIFO's medium-term outlook of May 2022. WIFO's March outlook assumes real GDP growth in Austria to come to 3.9% in 2022 and 2.0% in 2023. In the years after 2023, economic activity is expected to expand at a moderate pace, with real GDP growth remaining below 2%.

As in times of great uncertainty economic outlooks may be revised within rather short periods of time (e.g. at quarterly intervals, as is the case with WIFO's economic outlook), even relying on the latest available WIFO outlook entails the risk that the starting point of our fiscal forecast might become obsolete rather quickly. For this reason, our current fiscal forecast outlines the fiscal effects of economic developments deviating from WIFO's forecast. This is to provide readers with a basis for independently gauging the fiscal effects that different macroeconomic shocks might have on Austria's public finances. Fundamental changes affecting goods manufacturing or the loss of production factors (e.g. because of a suspension of Russian natural gas deliveries) cannot be covered in this analysis, however. Neither can we provide any estimate of the budgetary effects of economic policy measures that might become necessary. The recent slowdown in real GDP growth prompted by rising energy prices and the hike in inflation will cause a negative, if small, fiscal effect in the short run. In the medium term, we expect the general government budget balance to improve. The fiscal effect is largely being driven by rising inflation. When considered in isolation, the rise in inflation will cause the fiscal balance to slightly deteriorate in the short term, while an improvement can already be expected for 2023. In total, the improvement of the fiscal balance in 2023 will clearly more than offset the negative effect to be expected for 2022.

Economic recovery and economic policy measures determine the fiscal path following large pandemic-related deficits in 2020 and 2021

According to WIFO's economic outlook, the continuing recovery of the Austrian economy is set to substantially reduce the budget deficit. In its spring outlook, the Fiscal Advisory Council sees the fiscal balance improve from –2.9% of GDP in 2022 to –1.4% in 2023 (2020: –5.9% of GDP). Although many COVID-19-related support measures are now being phased out, government expenditure in 2022 will continue at the high levels seen in 2021 as new economic policy measures have been adopted, mainly with a view to addressing the effects of the war in Ukraine (packages to reduce the burden of high energy costs, building up natural gas reserves). Not least owing to our underlying no-policy change assumption, we expect a moderate rise in public expenditure from 2023. With the macroeconomic environment, which continues to be favorable to the fiscal outlook, and inflation combining to cause a strong rise in public revenue over the entire forecast horizon, the budgetary impact of the eco-social tax reform, which will materialize from mid-2022, will be more than offset. From today's perspective, and based on our no-policy change assumption, Austria's general government is forecast to generate a surplus from 2025 onward (cutoff date for data for this outlook: May 25, 2022).

Above-average growth of general government revenues in the medium term, normalization of expenditure path from 2023

Even though the strong catching-up process observed in 2021 has begun to decelerate, public revenues will post high average growth at a rate of 4.3% per annum in the period from 2022 to 2026 (average annual growth for the 2015 to 2019 period: 3.2%). In 2022, general government revenues will amount to EUR 213.0 billion or 49.1% of GDP. Austria's public revenue ratio is thus lower than last year (2021: 50.0% of GDP), which is attributable to a number of measures (e.g. packages to reduce the energy cost burden, easing of tax depreciation, initial measures of the eco-social tax reform) that cause public revenues to grow at a slower pace than nominal GDP. In the coming years, the revenue ratio is expected to remain just under 49% of GDP.

Public expenditure will come to a total of EUR 225.8 billion, or 52.1% of GDP, in 2022 (+0.1% year on year) on the back of anti-inflationary measures that will offset the decrease in expenditure caused by the winding-down of pandemic-related measures. This slight increase is also fueled by rises in expenditure related, inter alia, to the climate bonus and the building-up of national strategic natural gas reserves. In the years from 2023, net spending will again reflect mixed effects: On the one hand, expenditure will be dampened as COVID-19-related measures and temporary measures related to inflation are increasingly being phased out and the one-off costs incurred in 2022 for building up gas reserves will no longer be a factor; on the other hand, the high inflation rates of 2022 will cause expenditure for the compensation of public sector employees to rise significantly in 2023. High 2022 inflation will only have an impact on pension expenditure in the course of the automatic pension adjustments in 2023 and 2024. All in all, expenditure growth will remain moderate in the period from 2023 to 2026, amounting to between 2.0% and 2.9%. The expenditure ratio will decline continuously over the observation period, to reach 48.3% in 2026, and will thus correspond approximately to its 2019 level of 48.6%.

Fiscal path for 2022 to 2025 plausible, although current stability program is altogether more pessimistic than our spring forecast

The government's stability program of April 2022 sees consistently larger budget deficits for the forecasting period from 2022 to 2024 than the medium-term fiscal path projected by the Fiscal Advisory Council this spring. For 2025, our spring forecast already assumes a small surplus, while the stability program still shows a small deficit. Our assumption primarily rests on our slightly more positive assessment of general government revenues in the short term, which primarily results from higher expectations of revenues from taxes on production and imports. In contrast, our forecast assumes lower revenues from taxes on income and wealth over the entire forecast horizon, as compared to the stability program. Our forecast sees general government expenditure grow at a slower pace than envisaged in the stability program throughout the forecasting period. Among other things, this is because we assume pandemic-related subsidies to decline faster and interest payments to be lower altogether than expected in the stability program. Moreover, the Fiscal Advisory Council forecast projects spending on intermediate goods to grow at a weaker pace and cash social benefits at a much weaker pace from 2023, which in total offsets the more pessimistic assumption regarding revenue growth from 2023.

Public debt ratio expected to continuously fall to below the 2019 pre-crisis level by 2026

The Fiscal Advisory Council's spring forecast starts from the assumption that Austria's general government debt ratio temporarily peaked in 2020 at 83.3% of GDP and that, following a slight decline by 0.5 percentage points to 82.8% of GDP in 2021, it will continue to decrease at a faster pace in the coming years. By 2026, it will fall to 67.7%, and thus to below the pre-crisis level (2019: 70.6% of GDP). This development will primarily be determined by the GDP denominator effect; from 2024, primary surpluses will also contribute to reducing the debt ratio.

Fiscal Advisory Council spring forecast expects Austria to meet both Maastricht criteria from 2022

According to our spring forecast, Austria's general government budget deficit (Maastricht definition) will be below the upper limit of 3% of GDP in 2022. Also, the reduction of the debt ratio is in line with the provisions of the Stability and Growth Pact (SGP), which means that only two years after the outbreak of the pandemic, Austria already fulfills both Maastricht criteria. The clear deviations from the Maastricht criteria in 2020 (fiscal balance, reduction of debt ratio) and 2021 (fiscal balance) are attributable to an unusual event that implied far-reaching uncertainty with regard to its macroeconomic and fiscal impact. Therefore, the European Commission had decided, already in spring 2020, not to launch excessive deficit procedures in any EU member states.

Based on the anticipated gradual improvement of key fiscal variables for Austria, we assume, from today's perspective, that Austria will be able to comply with SGP provisions over the medium term. Given the activation of the general escape clause, which was extended until end-2023 given the present situation of enormous uncertainty and which allows deviations from the structural budget requirements imposed by the SGP (structural budget balance, spending rule) for 2020 to 2023, we refrain from a quantitative assessment of any such deviations. Once the general escape clause is deactivated, according to our spring forecast and based on a no-policy change assumption, Austria's structural deficit will be continuously reduced in line with the SGP. In a first step, Austria would be able to return to a structural adjustment path toward the medium-term objective (MTO), i.e. a structural budget deficit of a maximum of 0.5% of GDP, which would be reached in 2024.

We continue to refrain from making an ex ante assessment of national fiscal rules according to Austria's 2012 National Stability Pact as long as the general escape clause applies, the specific uncertainties surrounding the drafting of subsectoral budget plans persist and the underlying data continue to change fast.

Recommendations by the Fiscal Advisory Council on Austria's budget policy for 2022

Temporary monetary government transfers targeted at lower-income households need to be quickly adopted and paid out to cushion the effect of high price increases; additional government revenues resulting from higher inflation need to be used to preserve some fiscal space and to finance inflation-induced additional expenditure.

Background:

Since early 2022, inflation has increased sharply, driven primarily by energy prices. This is a big challenge, in particular for low-income households. First analyses prepared by WIFO (Research Brief 10/2022) and the Fiscal Advisory Council show the potential effects the rising cost of living has on the poorest households in Austria. From results based on the Fiscal Advisory Council's microsimulation model, we see that among the lowest-income 25% of Austrian households, spending on consumption was already higher than income at 2019-2020 prices. Moreover, based on first quarter 2022 price growth, the increase in private consumption expenditure driven by the growth of household consumption prices has been rising with income. As a result, the poorest 35% of households are only just about able to cover their consumption expenditure, and the gap between income and consumption expenditure is widening for the poorest 25%.

Even though economic researchers expect price growth to slow down significantly as soon as 2023, inflation is still likely to remain clearly above the ECB's medium-term symmetric inflation target of 2%. This means that inflation will continue to be high on the policy agenda for several years to come.

Recommendations:

- Targeted monetary government transfers need to be paid to lower-income households for a limited period to cushion the effect of high prices increases. To make these transfers as effective as possible, the different levels of government should act quickly, efficiently and in a coordinated manner.
- The amount of transfers needs to be based on the additional cost resulting from the inflation of prices of goods consumed by poorer households. This means that both the level of household income and households' exposure to inflation should determine the amount of transfers. The transfers to households should be temporary because they serve to bridge the time gap between price increases and increases in wages, government transfers (including social assistance, unemployment benefits, long-term unemployment assistance) and pensions. The technical and administrative challenges involved in implementing income-dependent transfers to households should be addressed quickly and in a cost-efficient way.
- In addition, social transfers in general should be raised to maintain the real purchasing power of all income from transfers.
- Moreover, tax measures could facilitate the conclusion of wage settlements between employers' and employees' representatives, thereby contributing to slowing the pace of inflation.
- Fiscal prudence is warranted to preserve fiscal space for the near future: higher inflation-induced government revenues should not be used hastily to implement permanent tax cuts. The fiscal space that has opened up for the short term is small, given that the prevailing high inflation has also driven up government expenditure. Any such space should be used as a reserve for funding renewed support measures that might become necessary in a deepening economic crisis. This would help to somewhat slow the expansion of government debt.
- To be able to respond efficiently to new or recurring crises and address new challenges in a timely manner, a scientific evaluation needs to be performed to assess the effectiveness and adequacy of support measures adopted to cushion the effects of the COVID-19 crisis and high inflation.
- Any changes to the economic policy strategy, in particular regarding crisis-induced government aid, need to be communicated clearly and in advance to allow businesses and households to plan ahead.

Enabling future investments by aiming for system efficiency in structural reform areas involving multiple levels of government and by ensuring sustainable funding for long-term care

Background:

The Fiscal Advisory Council expects that once all COVID-19-related support measures for companies and households have expired, the government expenditure ratio will drop significantly, reaching 49.2% in 2024, a level clearly below the 51.2% recorded in 2012. The reason for this is the sharp decline in the government interest expenditure-to-GDP ratio from 2.7% to 0.9%.

Our fiscal sustainability report of September 2021 found that government expenditure on health and long-term care services must be expected to increase particularly strongly in the long term, from 7.1% and 1.2% of GDP, respectively, in 2019 to 9.9% and 3.1%, respectively, in 2070.

The recently announced reform of long-term care in Austria should bring about improvements for care professionals, training, cared-for persons and caregiving relatives as well as 24-hour care at home. These include a monthly bonus payment for caregivers, a monthly allowance for caregivers in training, and the introduction of care worker apprenticeships (on a trial basis) throughout Austria. How these measures are going to be funded has so far not been communicated in detail by the federal government.

Recommendations:

- Structural reforms – especially as regards the division of powers and responsibilities between the individual levels of government – should utilize existing efficiency-enhancing potential in order to slow down the growth of demographically-driven increases in social expenditure. A transparent overview of the status quo is a prerequisite for achieving this goal. The most important issues that need to be addressed in this context include the broad dispersion of responsibilities across different levels of government and social security institutions and, in particular, the financial interlinkages in the health and long-term care systems.
- Measures to ensure the long-term sustainability of care services, e.g. by making the care profession more attractive or expanding the range of services provided, are welcome steps, which reflect overall political priorities. That said, reorganizing the long-term care system should also include the coordinated planning of demand, joint management by objectives and sustainable funding. The latter in particular requires clear political decisions, which, however, have not been made so far.
- Structural reforms affecting all levels of government should be prepared now, during the window of opportunity provided by the prolongation of the current fiscal sharing agreement until 2023. One of the major points to be addressed are the lacking links between responsibilities for service provision, spending and revenues.

Meeting CO_2 emission targets requires creation of fiscal space

Background:

The EU Effort Sharing Regulation requires Austria to reduce its CO_2 emissions by 36% by 2030 compared to 1990 levels (this target concerns emissions from sectors currently not included in the EU Emissions Trading System). However, the targets laid down by the European Commission in its "Fit for 55" legislative package in July 2021 imply that Austria must reduce its greenhouse gas emissions by even 46% by 2030, underlining an urgent need for action.

Apart from that, the federal government has set itself the goal of making Austria climate neutral by 2040, which implies an even more ambitions path of emissions reduction. Empirical evidence shows that Austria is still a long way from reaching the targets imposed at the EU level by the "Fit for 55" package and the Green Deal as well as those laid down in the current government program ("climate neutral by 2040"). Against this backdrop, promoting public and private investments and strengthening capital markets will be of key importance.

Recommendations:

- More effort is needed to achieve the ambitious national and international climate targets. The choice of appropriate measures should also be based on the cost efficiency of the technologies available for reducing CO_2 emissions.

- Public funds will have to be freed up to implement the measures necessary to meet the emission targets. In this context, higher-quality public finances need to be made a priority; in other words, the share of investments in overall expenditure should be high. At the same time, we will need a balanced mix of incentives and regulatory requirements (e.g. subsidies, regulations, CO_2 pricing) to encourage and ensure broad involvement across the private sector, i.e. companies and households. Public and private investment can raise the long-term growth potential, help address the challenges of climate change – and also seize the opportunities it may imply – in a targeted manner and help avoid financial sanctions that could be imposed for noncompliance with climate policy targets.