PUBLIC FINANCE REPORT 2020–2025 FOR AUSTRIA (DECEMBER 2021) – KEY RESULTS AND RECOMMENDATIONS

Assessment of Austria's fiscal situation from 2020 to 2025

At the end of February 2020, the first person in Austria tested positive for COVID-19. In the months that followed, unprecedented challenges emerged not only for health care and society at large but also for the economy and fiscal policy, and these challenges are still ongoing.

This means that we again had to prepare our public finance report under particularly challenging conditions, as any assessment of the fiscal and overall economic impact of the pandemic is subject to considerable uncertainty. Though we have gained some knowledge from the complex effects of previous lockdowns, which have differed in terms of scope, regional coverage and duration, there is still high uncertainty about how the epidemiological situation will evolve and whether further restrictions will become necessary. For example, it is difficult to say at the moment how long the current – fourth – lockdown, which started on November 22, 2021, will eventually last and whether any follow-up measures will be necessary.

Against this background, the current fiscal forecast offers its readers an integrated "tool" for independently gauging the impact of longer-lasting or renewed restrictions (lockdown measures) on government budget balances. To this end, we need to distinguish between "hard" and "partial" lockdowns. According to our estimates, the overall budgetary effect of the fourth lockdown, which we assume will include three weeks of hard lockdown and seven weeks of partial lockdown, will be EUR 0.7 billion for each hard lockdown week and EUR 0.4 billion for each partial lockdown week. The budgetary effect has a macroeconomic and an economic policy component, with the costs of economic policy measures exceeding the fiscal impact of the macroeconomic downturn. Such scenario analyses can be used to adjust the Fiscal Advisory Council's fall forecast (cutoff date: November 12, 2021) presented in this report to new developments. Our fall forecast is based on the most recent economic forecast published by the Austrian Institute of Economic Research (WIFO) in early November. Taking into account the macroeconomic effects of the ecological and socially balanced ("eco-social") tax reform, this forecast predicts a recovery with real GDP growth rates of 4.4% and 5.0% for 2021 and 2022, respectively.

COVID-19 pandemic continues to affect key fiscal variables for Austria

The fiscal impact of the COVID-19 pandemic consists of the costs of active government intervention designed to support the economy and the effects of automatic stabilizers through which the economic downturn feeds through to public finances. While the costs of economic intervention are mainly reflected on the expenditure side (support measures), the fiscal effects of the economic downturn materialize primarily as losses in tax income on the revenue side. We calculated the fiscal impact of the pandemic (excluding the fourth lockdown) to total EUR 63.8 billion for the period 2020 to 2022; the costs of discretionary measures account for around 60% of this amount, and around 40% are attributable to the macroeconomic shock.

The overall effect caused an unprecedented deterioration in the general government balance, causing it to drop by 8.9 percentage points to –8.3% or –EUR 31.5 billion in 2020. According to the Fiscal Advisory Council's current forecast, the general government balance is set to already improve to –5.4% or –EUR 21.7 billion in 2021 on the back of the economic recovery. We expect a further improvement to –1.6% or –EUR 7.1 billion in 2022 as government support measures expire and the upswing continues. Assuming a three-week hard lockdown followed by a seven-week partial lockdown, our calculations suggest a deterioration in the 2021 and 2022 general government balances by 0.8% and 0.4% of GDP, respectively. This does not affect the qualitative result of a markedly improving general government balance, however.

This trend will continue in the following years until 2025, even though the fiscal effects of the eco-social tax reform will be kicking in fully. The government debt ratio will continuously drop throughout the whole period, falling from 83.2% of GDP in 2020 to 67.9% of GDP in 2025 and thus clearly below the pre-crisis value of 2019 (70.6% of GDP).

2020 saw historic slump in government revenues and sharp increase in public spending due to COVID-19 pandemic

Due to the COVID-19 pandemic, general government revenues plunged by EUR 10.6 billion or 5.4% in 2020 against the previous year to EUR 184.9 billion. This decline was multiple times larger than the slump recorded in 2009 (–EUR 1.5 billion against 2008) in the wake of the global financial and economic crisis. It was the result of discretionary tax cuts worth EUR 3.5 billion (in particular, the temporary reduction in VAT from July 2020 and the reduction of the tax rate in the lowest income tax bracket) and nondiscretionary developments on the revenue side amounting to –EUR 7.0 billion (in particular, due to the lower tax base because of the recession). Tax revenues dropped by 8.6% against the previous year, that is, by much more than nominal GDP (–4.6%). The decline in revenues was particularly pronounced in corporate tax (–28.3%), assessed income tax (–30.8%) and petroleum tax (–20.1%). In addition, the steep drops in proceeds from VAT (–6.6% or –EUR 2.0 billion) and payroll taxes (–3.5% or –EUR 1.0 billion) contributed significantly to the absolute decline in revenues, given these tax types' big share in overall tax revenues. Finally, proceeds from government production activities (including ticket sales by the Austrian Federal Railways (ÖBB) and public cultural institutions) also fell by EUR 0.7 billion.

Government expenditure increased substantially by 12.1% or EUR 23.4 billion in 2020 compared to the previous year, reaching EUR 216.4 billion. This steep rise was mainly due to the economic slump caused by the pandemic and government spending on measures to cushion the economic and social impact of the public health crisis. The biggest part of the increase – EUR 17.3 billion – was attributable to the direct budgetary effect of pandemic-related government support measures, in particular the COVID-19 short-time work scheme (EUR 6.1 billion), fixed cost grants (EUR 2.8 billion), compensation for lost sales (EUR 3.6 billion), the hardship fund (EUR 0.9 billion) and additional health services (EUR 0.9 billion). In 2020, high unemployment in the wake of the recession markedly drove up spending on unemployment benefits, i.e. by EUR 2.5 billion. While payments from the hardship fund and unemployment benefits significantly contributed to a rise in cash social benefits (+EUR 6.4 billion), it was mainly increased spending on short-time work, fixed cost grants and compensation for lost sales that led to a hike in subsidies (+EUR 13.3 billion). Government spending was also driven up by a marked increase in pension expenditure (+5.2%), primarily owing to extraordinary pension adjustments (+EUR 0.4 billion per annum) and some smaller measures (e.g. the "pension bonus," i.e. higher minimum pension benefits for retirees with 40 years of contributory service, temporarily full pension entitlement after 45 years of contributory service, the "early starter bonus," i.e. higher pension benefits for those who started working before the age of 20). The 2020 increase in government spending was somewhat mitigated by the fact that interest expenditure again markedly declined, by EUR 0.6 billion, thanks to persistently low interest rates.

Revenue situation in 2021 driven by economic recovery; measures to counteract the COVID-19 crisis will not be phased out before 2022 thus still affecting government spending

The year 2021 has been marked by economic recovery, which is also clearly reflected in revenue growth. Following the slump in 2020, government revenues are expected to increase by 7.8% or EUR 14.4 billion in 2021 on the back of the economic recovery, already surpassing their pre-crisis level of 2019. The growth in tax revenues is particularly marked (+11.1%) and will remain disproportionately high (though lower) in the following years despite the severely dampening effect of the eco-social tax reform (income tax cut, reduced health insurance contributions, higher write-off limits for low-cost assets, corporate tax cut, green investment tax allowance, higher profit allowance, etc.).

The expenditure-increasing effect of COVID-19-related measures continues into 2021 and will only come down significantly in 2022: According to the Fiscal Advisory Council's fall forecast, government expenditure in 2021 is set to increase by 2.1% or EUR 4.6 billion. On the one hand, spending on COVID-19-related measures will decline by EUR 1.7 billion, and low inflation in the preceding year will also bring down expenditure through the automatic adjustment of pension and long-term care benefits and lower spending on intermediate goods. On the other hand, present and past economic policy measures are driving up government expenditure by EUR 2.4 billion in 2021 (spending under Austria's recovery and resilience plan (+EUR 0.4 billion), extraordinary increases in pension benefits (+EUR 0.4 billion), measures for climate and environmental protection (+EUR 0.5 billion), etc.). In 2022, COVID-19-related spending is expected to decrease substantially, i.e. by EUR 12.8 billion to EUR 2.8 billion, which means that further effects on the budget will be limited to instances where the government may need to honor public COVID-19 guarantees, payments of the investment premium and effects in the area of health-related spending. However, there are also ordinary expenditure increases scheduled for 2022 (e.g. inflation-related increases in the cost of intermediate goods and social benefits) and an expansion of economic policy measures (other than COVID-19-related measures) by EUR 2.9 billion (e.g. climate bonus), causing government spending in 2022 to only decrease by EUR 3.8 billion year on year. In 2023, spending will increase by 2.9%, mainly because of higher inflation in 2021 and 2022 that is driving growth in social spending and employee compensation. For 2024 and 2025, we expect a rise in expenditure by 1.5% and 2.3%, respectively.

Results of the BMF draft budgetary plan for 2022 plausible but hard to compare to the Fiscal Advisory Council's fall forecast

The draft budgetary plan for 2022 and the strategy report for 2022 to 2025 was published by the Federal Ministry of Finance (BMF) in October 2021. For 2021 and 2022, the BMF's draft budget assumes general government balances of –6.0% and –2.3% of GDP, respectively. According to the strategy report, the budget deficit should contract further, reaching –0.4% in 2025. The comparability of these values with the results of the Fiscal Advisory Council's current fall forecast is limited, as the BMF draft budgetary plan and its strategy report were prepared much earlier. This means that the BMF calculations do not reflect the macroeconomic effects of the eco-social tax reform that are already included in the current WIFO forecast on which we base our calculations. Hence, the Fiscal Advisory Council's fall forecast is slightly more optimistic about the budget balance, putting it at –5.4% for 2021 and –1.6% for 2022. The different underlying macroeconomic forecasts account for some differences, to the extent of 0.1 percentage points in 2022, and up to 0.5 percentage points by 2025 due to the gradual expansion of the tax reform. Moreover, our fall forecast assumes somewhat more favorable revenue growth, in particular in 2021, but also lower expenditure – in the area of social benefits and capital transfers among others.

Expected economic rebound and phasing-out of COVID-19 support measures pave the way for compliance with both Maastricht criteria from 2022

The clear deviations from the Maastricht criteria in 2020 (fiscal balance, failure to reduce debt ratio) and 2021 (fiscal balance) are attributable to an unusual event that implies far-reaching uncertainty with regard to its macroeconomic and fiscal impact. Therefore, the European Commission 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 the provisions of the Stability and Growth Pact (SGP) over the medium term. Given the activation of the general escape clause, which allows deviations from the structural budget requirements imposed by the SGP (structural budget balance, spending rule) for 2020 to 2022, we refrain from a quantitative assessment of related deviations. However, for the first time since the onset of the public health crisis, the improved economic outlook makes it possible to produce a more plausible estimate of the output gap and hence the structural budget balance; therefore, we have once again included the structural budget balance in our review of key fiscal variables in this report – although

any estimates of the output gap and the structural budget balance should still be interpreted with caution.

According to our fall forecast, the structural deficit will be continuously reduced in line with the SGP once the application of the general escape clause is revoked at the end of 2022. This means that Austria, in a first step, will 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, and then, by 2024, will be able to reach the MTO – provided that fiscal rules remain unchanged and based on the current method for estimating potential output.

Although the fiscal position substantially deteriorated in 2020 there will be no sanctions as the general escape clause is also applied to national fiscal rules

As agreed on the EU level, there will be no evaluation of rules compliance for the years 2020 to 2022 – also in the context of national fiscal rules – and hence no determination of breaches that might usually entail financial sanctions. Against this background, the substantial deterioration in key fiscal variables that is already evident on all levels of government for 2020, but also potential deviations in subsequent years, will not entail financial penalties. At this point, we also cannot evaluate the upcoming years (2023 to 2025), as the regional and local governments will not provide their medium-term budgetary plans (submitted for each province) pursuant to Article 15 of the Austrian Stability Pact of 2012 until end-2021, meaning that we do not have a basis for a future-oriented analysis of national fiscal rules compliance at the moment.

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

Changing environment for health care, social and economic policies needs to be carefully monitored to allow well-targeted government crisis intervention

Background: In its current forecast, the Fiscal Advisory Council anticipates a steady improvement of Austria's fiscal position, following the unprecedented deterioration in public finances seen in 2020 in the wake of the COVID-19 pandemic. According to our forecast, the general government deficit will already fall below the deficit limit of 3% of GDP in 2022; the general government debt ratio will return to pre-crisis levels in 2025, reaching 67.9% of GDP. However, the Austrian budget and debt path is still subject to considerable uncertainties as the future course of the pandemic and further measures necessary to contain its spread remain unclear. Likewise, the budgetary impact of the already fourth "hard" lockdown in Austria imposed toward the end of 2021 cannot be conclusively assessed at this point.

Recommendations:

- The persistent on-and-off crisis mode urgently calls for a scientific evaluation of the support measures implemented by the government. The measures need to be evaluated in terms of their effectiveness and adequacy to enable policymakers to deal with new challenges and a changing environment in a timely manner. If governments across Europe actively end the far-reaching state intervention that has accompanied the pandemic, they need to strike a balance, above all between returning to sustainable fiscal policies and fulfilling their macroeconomic stabilization function.
- Any changes to the economic policy strategy, in particular regarding COVID-19-related government aid, need to be communicated clearly and in advance to allow businesses and households to plan ahead.
- The currently favorable market interest environment should be used to extend the residual maturity of Austria's government debt.

Austrian government should use medium-term fiscal space for structural reforms and growth-enhancing investments

Background: In line with our current fiscal forecast, we expect that Austria will be able, over the medium term, to return to the sound fiscal position that existed prior to the onset of the COVID-19 pandemic – thanks to the economic recovery and the phasing-out of pandemic-related fiscal measures. However, our sustainability analysis raises some issues: Cost increases driven by demographic change alone would be sufficient to call into question the long-term sustainability of public finances, with climate policy adding additional pressure.

Recommendations:

- As is also evident from the Fiscal Advisory Council's current fall forecast, there appears to be some fiscal space in the medium term despite considerable uncertainty. This fiscal space needs to be used for structural reforms and growth stimulus packages, in particular for investments, so as to address the fiscal gap identified on the long-term horizon in a timely manner and under comparatively favorable conditions.
- In the Fiscal Advisory Council's opinion, reforms are particularly needed to raise efficiency, sustainably cope with cost increases and ensure sustainable funding in spending areas that are driven by demographic change, including above all pensions and health care. In the area of long-term care, efficiency gains should be used (among other elements) to cope with the expected cost increases more easily.

- In light of demographic change, policymakers need to encourage increased labor force participation among older people, but also among women, who often work part-time, to support the long-term growth potential as well as sound government finances.

- For tasks that involve different levels of government, inefficiencies and steering problems should be addressed by raising transparency, strengthening the coherence of tasks and revenue and spending responsibilities, and by disentangling joint tasks. This could be achieved by introducing a new fiscal sharing plan ensuring a more task-based allocation of funding and simpler structures with fewer transfers of funds between the different levels of government, but also by strengthening the tax autonomy of provinces and municipalities. On this basis, it should be possible to come up with a fair distribution of costs and adequate funding for all levels of government. In this context, safeguarding investment activity and services of general economic interest at the local level is also very important.

- The pandemic has clearly exacerbated education deficits. To actively counteract possibly harmful effects on our society and on potential growth, an education campaign should be started with the aim of generating efficiency gains in the elementary, primary and secondary school sector. Initiatives to promote further training and reskilling are also necessary. All the above steps are crucial to also address the shortage of skills.

- Higher-quality public finances need to be made a priority, i.e. the share of investments in overall expenditure should be high. Public investments can raise the long-term growth potential, help address the challenges and seize the opportunities implied by ecological and digital change in a targeted manner, and help avoid financial sanctions that could be imposed for noncompliance with climate policy targets.

- Ad hoc expenditure increases (as increasingly seen in recent years in the area of pension expenditure) and tax cuts that are not guided by an overall strategy and that represent a lasting and irreversible burden on government finances should be avoided.

Strategic approach to subsidization should increasingly reflect the growing importance of climate policy

Background: The Fiscal Advisory Council welcomes the first steps to reduce greenhouse gas emissions under the eco-social tax reform. After all, beyond its climate policy, social and economic dimension, noncompliance with internationally agreed climate goals also implies financial penalties. 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"). Given these challenges, promoting public and private investments and strengthening capital markets is decisive.

Recommendations:

- To further reduce CO_2 emissions and realize related climate goals, policymakers need to quickly evaluate the effectiveness of the necessary measures and incentives (above all public infrastructure investments, greening of the tax system, CO_2 pricing, legal requirements, subsidies). Where necessary, these measures and incentives need to be expanded and aligned more closely. This also holds for initiatives at the EU level.

- A holistic strategy and increased transparency regarding the goals of subsidization, the used resources and the desired effects could lead to efficiency gains for strategic subsidization in Austria, while also allowing a stronger focus on ecological components and avoiding unwanted duplication of subsidies. This means, above all, that subsidies granted by different levels of government should be better coordinated and more closely aligned.

Steering effect of national fiscal framework needs to be improved

Background: Through its regular monitoring activities, the Fiscal Advisory Council has gained valuable insights into the quality of data used under the Austrian fiscal framework and the design of national fiscal rules. The issues we have identified with regard to the application of the Austrian fiscal framework (i.e. the Austrian Stability Pact of 2012) concern, in particular: (1) the complexity of the national framework, (2) the rules' small steering effect, (3) the operationalization of the framework after the deactivation of the "general escape clause" and (4) the validity of data.

Recommendations:

- A reform of the Austrian Stability Pact should above all focus on reducing the complexity of rules, while at the same time improving their steering effect, to support the return to sound budget and debt paths for all levels of government.
- In particular, the target values of the prescribed (rigid) debt path need to be adapted to reflect the wholly new debt situation arising from the pandemic. Also, the current subsectoral composition of debt must be adjusted based on the most recent year for which data are available.
- The usefulness of the national spending rule as a fiscal steering instrument should be increased through simplification and by linking its operationalization to observable variables.