KEY RESULTS OF THE FISCAL ADVISORY COUNCIL'S REPORT ON PUBLIC FINANCES 2019 TO 2021 (AS OF DECEMBER 2020)

Assessment of the fiscal situation from 2019 to 2021

This report was prepared under the particularly challenging conditions brought about by COVID-19, which made it necessary to continuously evaluate government intervention to contain new infections and to support the economy, the labor market and incomes. In addition to its far-reaching health and social effects, the crisis is having an enormous fiscal and macroeconomic impact, and any assessment of the scale of this impact is fraught with considerable uncertainty at the moment. The Fiscal Advisory Council's 2020 fall forecast is based on an updated projection by the Austrian Institute of Economic Research (WIFO) of November 2020. Taking into account the impact of the "light" lockdown (closure of hospitality, ban on events), this projection sees real GDP drop by 7.7% in 2020, which would be the worst economic slump since World War II. The further tightening of lockdown rules (closure of retail shops, personal care businesses and schools) imposed in mid-November is reflected in the Fiscal Advisory Council's forecast through additional adjustments to government revenues, unemployment benefits and discretionary support on the basis of our own analyses (cutoff date: November 26, 2020).

COVID-19 pandemic causes severe deterioration of Austria's fiscal indicators

The measures taken by the government to support the economy, including economic stimulus provided by the central government and regional governments, include immediate aid, the corona assistance fund and the corona short-time work scheme as well as tax deferrals, a reduction of advance tax payments and guarantees. 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 estimates the fiscal burden (deficit effect) of the COVID-19 pandemic at EUR 38.3 billion in 2020 and another EUR 22.5 billion in 2021. This estimate includes not only the cost of the support measures (reflected mostly on the expenditure side) but also the impact of the economic slump (mostly on the revenue side).

The COVID-19 pandemic is causing a historic deterioration of the general government budget balance from +0.7% of GDP (2019) to –10.1% of GDP in 2020 and –6.4% of GDP in 2021, according to the Fiscal Advisory Council's forecast. Austria's general government debt ratio is set to rise from 70.5% of GDP in 2019 to 84.8% of GDP in 2020 and to 87.1% of GDP in 2021. While in 2020 the debt ratio is being driven up mainly by the high primary deficit and the contraction of GDP ("denominator effect"), in 2021, the economic recovery and debt-reducing stock-flow adjustments (also because of the ESA recording of tax deferrals) are expected to slow down the increase in the debt ratio. Given the parallel development of revenues and nominal GDP, the revenue ratio has been changing relatively little, dropping from 49.1% of GDP in 2019 to 48.2% and 47.8% in 2020 and 2021, respectively. At the same time, the expenditure ratio is set to climb from 48.4% of GDP in 2019 to 58.3% and 54.2% in 2020 and 2021, respectively, mostly due to discretionary spending.

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

According to the Fiscal Advisory Council's forecast, general government revenues are set to drop by an unprecedented EUR 14.5 billion (or 7.5%) to EUR 180.6 billion in 2020 compared to the previous year. This decline is much steeper than the slump recorded in 2009 in the wake of the global financial and economic crisis (–EUR 1.5 billion against 2008). The factors contributing to the current deterioration are discretionary measures reducing revenues by EUR 5.0 billion (including, in particular, a temporary cut in VAT, options of loss carryback and an income tax cut in the lowest tax bracket) and a EUR 9.5 billion

decline in revenues due to the macroeconomic shock. Revenues are expected to increase only moderately in 2021 – by EUR 6.1 billion (or 3.4%) to EUR 186.7 billion – as the recovery will be slow and the effects of additional revenue-reducing measures will be taking hold (including a prolongation of the temporary VAT cut for the whole of 2021, tax relief and support measures for restaurants and accelerated depreciation). According to the Fiscal Advisory Council's forecast, the option to defer federal taxes without interest penalty will postpone revenues of EUR 0.6 billion in ESA terms from 2020 to 2021 (this amount already takes into account a rate of default of 20%).

At the same time, government expenditure is rising at an exceptional pace because of the public support measures: The Fiscal Advisory Council sees government spending increase by EUR 25.8 billion or 13.4% to EUR 218.3 billion in 2020 compared with the previous year, before dropping by EUR 6.6 billion or 3.0% to EUR 211.7 billion in 2021, which will be mostly due to the expiry of temporary measures. Direct COVID-19-related support measures account for EUR 19.0 billion of the increase in expenditure in 2020; in 2021, this effect will decrease to EUR 4.3 billion. Such measures include above all short-time work schemes, fixed cost grants, the hardship fund and compensation for sales losses. Other measures adopted in 2020 include funds to encourage environmental investment (e.g. funds granted under the Environmental Support Act, scaling up of renewable energy, investment in climate-friendly innovations) and labor market support measures (e.g. funds for qualification and training, digitalization); taken together, these measures push up expenditure by a further EUR 1.8 billion and EUR 3.2 billion in 2020 and 2021, respectively.

Adjustment of underlying data needed for plausibility check of Ministry of Finance's 2021 budget

The results of the Fiscal Advisory Council's forecast cannot be directly compared with the Federal Ministry of Finance's 2021 budget, which was presented in October. The latter was based on the then current WIFO forecast, which did not include a second lockdown, and assumed a general government budget balance of –9.5% of GDP and –6.3% of GDP in 2020 and 2021, respectively. The plausibility check of the Federal Ministry of Finance's figures was based on the quick assessment published by the Office of the Fiscal Advisory Council at end-October 2020, which rested on the same macroeconomic assumptions. The quick assessment was slightly more optimistic about the budget balance, putting the deficit at –9.2% and –5.8% for 2020 and 2021, respectively. Given the prevailing high uncertainty of estimates, this deviation can be considered small. Also, the Office of the Fiscal Advisory Council expected revenues to be somewhat higher across all main categories (except social security contributions), while general government expenditure was forecast to be slightly higher in 2020 and lower in 2021 compared with the Finance Ministry's budget. These deviations are likely to be attributable to the ministry's assumption that the funds budgeted for several COVID-19 support measures (in particular short-time work schemes and fixed cost grants) will be used up in full and a larger part of guarantees will be called early.

No SGP procedures despite excessive deficit and debt ratios in 2020 and 2021 because of unusual conditions caused by COVID-19

In 2019, Austria was clearly in compliance with the Maastricht criteria (deficit threshold of 3% of GDP, sufficiently fast reduction of the government debt ratio); from 2020 on, however, Austria is set to significantly deviate from the targets. These deviations in 2020 and 2021 are attributable to the COVID-19 pandemic, 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 Member States.

In 2019, Austria met its medium-term budget objective (MTO) of a structural budget deficit of no higher than 0.5% of GDP. According to the European Commission's ex post evaluation in spring 2020, which is relevant for the final assessment, the structural budget balance was –0.3% of GDP, whereas nominal

expenditure growth was significantly above the general government benchmark according to the EU definition. However, as long as the MTO is complied with, noncompliance with the spending rule does not trigger procedural steps under the Stability and Growth Pact (SGP). For 2020 and 2021, the European Commission has activated the "general escape clause," which allows Member States to temporarily deviate from the structural budget targets (structural budget balance and spending rule) because of COVID-19. Hence, there will be no (numerical) review of structural budget figures for 2020 and 2021. Furthermore, the dramatic drop in GDP in 2020 and the comparatively modest recovery projected for 2021 imply downward revisions of potential output and corresponding upward revisions of the output gap for the past years – and these revisions are as significant as they are implausible. This means that for the time being and for some time after the end of the current crisis, there is no use in trying to interpret the output gap and the structural balance.

No sanctions for 2019 under national fiscal rules, general escape clause activated for 2020 and 2021

The budget balances reported by the regional and local governments in September 2020 – which, taken together, yielded a surplus of EUR 0.7 billion (including regional chambers) – and the EUR 1.8 billion surplus reported by the central government indicate some improvement of the balances on the corresponding control accounts. Control accounts record the deviations of actual (structural) government budget balances from their annual targets. The 2019 control account balances, which remain preliminary until adopted by the Austrian Coordination Committee in spring 2021, were positive at the central and regional levels and negative at the regional level. Between end-2018 and end-2019, the central government surplus had increased (to 0.235% of GDP), whereas the regional government surplus decreased slightly (to 0.723% of GDP). At the local level, the balance, which had been positive in the previous year, turned negative (–0.057%) as at end-2019. There were no threshold breaches at the different levels of government, which means that breaches by individual regional or local governments did not trigger any sanctions.

Only the province of Vorarlberg and its municipalities as well as the municipalities in Tyrol and Burgenland reported negative control account balances in 2019, which, according to the relevant rules, must be corrected without undue delay. This means that the correction of balances under the pro rata threshold must be initiated immediately after the deactivation of the general escape clause in 2022 and concluded by end-2023.

As agreed at the EU level, for the time being, there will be no ex ante evaluation of compliance with national fiscal rules for 2020 and 2021 owing to the activation of the general escape clause, which, according to Article 11 of the 2012 Austrian Stability Pact, also applies to national fiscal rules. Similarly, there has been no numerical evaluation of the debt path for 2020 and 2021 as prescribed in the 2012 Austrian Stability Pact, as the data currently available do not provide a useful basis for calculations.

Recommendations of the Fiscal Advisory Council on Austria’s budget policy for 2021

Thoroughly preparing and rigorously implementing the return to sustainable fiscal policy after COVID-19 pandemic

Background: The Fiscal Advisory Council’s current forecast expects the COVID-19 pandemic to cause a massive increase in Austria’s general government debt ratio from 70.5% of GDP (2019) to 84.8% and 87.1% of GDP in 2020 and 2021, respectively. This rise is attributable to the deep economic slump resulting from the economic and social lockdowns imposed in Austria, which has been accompanied by a global recession, as well as the government’s extensive support measures to contain the economic and social impact of the pandemic. Real GDP is set to contract by at least 7.7% in 2020, according to the Austrian Institute of Economic Research (WIFO). The Fiscal Advisory Council estimates that the pandemic’s overall fiscal cost (deficit effect) will amount to EUR 38.3 billion in 2020 and EUR 22.5 billion in 2021, with the support measures showing mainly on the expenditure side and the impact of the economic slump primarily reflected on the revenue side.

The experience of the 2008 financial crisis showed that a rigorous path toward restoring sound fiscal positions not only provided the basis for achieving excellent credit ratings and, consequently, particularly favorable funding conditions for Austria's central government but also created the room for maneuver necessary for the large-scale government intervention during the current crisis situation. In contrast to the financial crisis of 2008, the ongoing low interest environment is now one of the factors that will make it easier to return to a sustainable fiscal path.

Recommendations:

- The Fiscal Advisory Council welcomes the extensive intervention measures all levels of government in Austria have taken to fight the COVID-19 pandemic and its social and economic impact within their mandate to safeguard stability. After the end of the pandemic, the government needs to withdraw from the temporary support and stimulus measures in an orderly and business cycle-compliant way to bring the country back on a path toward sustainable public finances. In addition, once the worst phase of the pandemic is over, the government needs to take stock of the budget situation and develop a medium-term plan for reducing the budget deficit and the debt ratio. To the extent possible, such a fiscal path should ensure planning certainty for stakeholders in society and the economy.
- An overall strategy should envision adjustments in particular in those areas that require strategic and structural reforms (the system of taxes and subsidies, pensions, long-term care). Such a strategy should be guided by economic policy objectives, sustainable funding and a clear division of responsibilities. It is crucial that the current crisis situation is not used as a vehicle to facilitate extraordinary ad hoc spending hikes or revenue reductions that are not directly related to the COVID-19 pandemic and its economic and social impact and that do not yield structural improvements but rather result in additional long-term fiscal costs. The current support measures must be effective in that they benefit those that suffer financially during the current crisis, and their effectiveness should be safeguarded through evaluation.
- Austria needs suitable measures to ensure high-quality regulatory impact assessments (RIAs) for legislative initiatives that have not been subject to strict RIAs so far (parliamentary motions, applications filed by parliamentary committees, legislative proposals submitted by the upper chamber of parliament and referendums). Also changes to legislative procedure need to be made subject to an RIA – before they are decided on – to ensure that there is a suitable basis for evaluation.
- Against this background, and in particular in an environment of ongoing high uncertainty, the

reestablishment of budget risk buffers in the medium to long term should go hand in hand with a well-prepared gradual tapering of support measures and the preparation and implementation of structural reforms. This means that despite the current crisis situation, preparations should continue for implementing structural reform plans (including the greening of the tax system, overhauling the system of subsidies, creating a sustainable structural and financial basis for long-term care, strengthening the long-term viability of the Austrian pension system). Such an approach could ensure that these structural reforms contribute to the long-term sustainability of public finances and the creation of fiscal space and would, at the same time, provide an important impetus for increasing the Austrian economy's growth potential and resilience in the long run.

- With a view to meeting long-term objectives, the government should use green investment not only for reducing CO_2 emissions to reach the targets enshrined in EU law but should also increasingly rely on green investment for stimulating economic activity. A balanced mix of instruments and incentives in line with EU requirements (public investment in infrastructure, greening of the tax system, CO_2 pricing, legal requirements) could trigger private sector investment, which would support the necessary economic recovery and structural change after the current crisis.

Maintaining local government investment and services of general economic interest, sustainable financing of more clearly defined areas of responsibilities under the fiscal sharing framework

Background: In 2018 and 2019, budget surpluses at the regional and local government levels contributed a crucial share – about EUR 0.7 billion or 0.2% of GDP each in both years – to Austria's sound fiscal position. The fiscal sharing architecture, i.e. channeling funds (in particular shared federal tax revenues) to regional and local governments, ensures that all levels of government are bearing a certain share of the burden and costs of the measures to cushion the social impact of the COVID-19 pandemic. This relates to both the drop in revenues resulting from the effects of automatic stabilizers following the slump in economic activity and the deliberate reduction of revenues to allow certain discretionary support and stimulus measures.

The decrease in tax revenues (above all from shared federal taxes, municipal tax and tourism tax) has created a funding gap affecting municipal investment and services of general economic interest – both key areas – despite additional federal funds granted under the Municipal Investment Act 2020 and COVID-19-related regional government funds. While the measures implemented at the federal level mainly aim at supporting the labor market and general economic activity, crisis-related spending at the regional and local government level focuses on social services (health care, childcare, long-term care, schools).

Recommendations:

- Municipal investment and services of general economic interest must be maintained, and the funding gap must be closed, in line with prudently set priorities, in order to ensure that local infrastructures and social services continue to be provided also under the presently challenging conditions.
- The parties to the fiscal sharing framework are called upon to agree on a fair distribution of costs and adequate funding for all levels of government. Aging and aging-related areas, like education, health care and long-term care, which so far have been the shared responsibility of the authorities at the different levels of government, are of particular importance in this context.
- The preparations for the fiscal sharing agreement shall be guided by a strong alignment of responsibilities with the power to tax and the power to spend, and by a heightened focus on tasks with a view to disentangling powers and funding responsibilities. A reform of federal structures must be initiated as soon as the COVID-19 pandemic is over.

Continuing with policies to strengthen the labor market as warranted by its special fiscal and social relevance

Background: The COVID-19 pandemic has brought the labor market upswing seen in the past few years to a sudden halt: For the first time in years, the number of payroll employees is projected to drop in 2020, by 2.0% or around 70,000. At the same time, the economic crisis and its massive impact on individual sectors, above all tourism and services as well as the leisure, entertainment and cultural sectors, is set to push up the number of unemployed persons by more than 100,000 to around 400,000. As a result, the unemployment rate (national definition) is forecast to increase from 7.4% in 2019 to 9.9% in 2020. In 2021, the labor market situation is expected to improve, but the number of jobless people will remain around 30% above the pre-crisis level of 2019.

In addition to its special sociopolitical importance, the labor market also plays an outstanding role in terms of fiscal relevance: About half of all general government revenues, in particular revenues from wage income taxes, social security contributions and the municipal tax, depend on the compensation of employees. Moreover, the number of unemployed persons has an immediate effect on social benefits in cash, just as the number of persons in short-time work schemes affects government subsidies (totaling EUR 11.9 billion in 2020, according to the Fiscal Advisory Council's current forecast).

Recommendations:

- The Fiscal Advisory Council reiterates its recommendation of May 2020, advocating a continuation of measures aimed at strengthening the labor market, also because of its high fiscal relevance. These measures include, in particular,
  - strengthening corporate liquidity, capitalization and aggregate demand in order to keep domestic businesses afloat,
  - scaling up placement, qualification and employment services provided by the Public Employment Service Austria (AMS) to counteract losses of qualification and an ensuing reduction of potential output. Special attention should be paid to measures that support young people entering the workforce and address long-term unemployment.

Creating the basis for a valid ex ante evaluation of national fiscal rules by operationalizing the general escape clause and making available recent data

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 (ÖStP 2012). 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.

On the basis of the current 2019 fiscal outcomes, both the province of Vorarlberg and its municipalities as well as the municipalities of Tyrol and Burgenland would have to initiate corrections "without undue delay" immediately after the deactivation of the general escape clause as of 2022. In a persistently difficult economic environment, such a mandatory correction would be a major challenge.

The activation of the general escape clause at the EU level and its mirroring in the national rules established a new regime for the application of rules, the operationalization of which remains unclear to date. The Fiscal Advisory Councils has identified need for action, above all with regard to the recording of control account balances and the strict debt-reduction path according to the ÖStP 2012: the aim should be to define targets on which governance is to be based on the one hand and to make it possible to take

into account the COVID-19-related deterioration in fiscal positions when performing evaluations on the other. Furthermore, the currently available data do not provide a useful basis for calculations for a valid ex ante evaluation.

Recommendations:

- The reform of the ÖStP should aim to enable good planning and governance; earlier proposals by the Fiscal Advisory Council should be taken into account. Also, the negotiations at the EU level about the practical implementation of the general escape clause, which are expected to get into full swing only in spring 2021, should feed into the reform.
- A database making available recent data should be established, as up-to-date data provide a crucial foundation for the evaluation of fiscal measures. This requires, on the one hand, an update of medium-term budgetary planning at all levels of government based on an agreed recent macro scenario and an estimate of future revenue shares and, on the other hand, the identification of national and regional COVID-19 measures and their fiscal effects based on a consistent stocktaking and costing approach.
- Rules for correcting negative control account balances that adequately reflect the requirements of the business cycle should be urgently established to avoid potential procyclical effects of such corrections.

Actively participating in the necessary reform of the EU fiscal framework by contributing previous experience

Background: The process initiated by the European Commission in early 2020 to review the effectiveness of the existing EU economic and fiscal framework focuses on the governance and surveillance elements of the Stability and Growth Pact (SGP) that were introduced or amended by the six-pack and two-pack reforms in 2011 and 2013, respectively. These elements include the procedure launched in case Member States deviate significantly from their medium-term budget objectives (MTOs), the operationalization of the debt rule and increased coordination among euro area countries through the evaluation of national fiscal programs. The review initiated by the European Commission brought to light both the strengths and weaknesses of the existing system, e.g. the complexity of the current fiscal rules, the procyclicality of fiscal policies and the fact that the share of investment in the public sector's total expenditure is only marginally taken into account.

The economic and fiscal dimension of the COVID-19 pandemic prompted the EU not only to launch a comprehensive crisis response (e.g. the recovery plan for Europe and the instrument for temporary Support to mitigate Unemployment Risks in an Emergency – SURE), but also to fully utilize the flexibility of the SGP in the application of numerical fiscal rules by activating the general escape clause. The general escape clause allows Member States to temporarily deviate from their MTOs (structural budget deficit of no more than 0.5% of GDP). Furthermore, the dramatic drop in GDP in 2020 and the comparatively modest recovery projected for 2021 imply major downward revisions of potential output and corresponding upward revisions of the output gap and the structural deficits of the past few years.

Recommendations:

- The Fiscal Advisory Council welcomes the European Commission's initiatives to review and enhance the EU fiscal framework, in particular the Stability and Growth Pact, and recommends that the Austrian federal government support the European Fiscal Board's proposal to conclude the reform process before the deactivation of the general escape clause. Swift decisions about a simplification of

the rules and the formulation of country-specific governance requirements provide the basis for sustainable fiscal policies and adequate surveillance, which will become crucially important soon after the end of the COVID-19 pandemic.

- The output gap and the structural budget balance should only be interpreted with particular caution for the time being, given that – if we apply the methods normally used for estimating and projecting potential output – the economic slump caused by the current health crisis would lead to downward revisions of potential output and, as a result, upward revisions of the output gap, also for the past few years, which would represent a statistical artefact rather than indicate an overheating of the economy. This estimation uncertainty will continue for some time after the end of the current crisis and the deactivation of the general escape clause.
- Austria should contribute its experience from the funding and support programs recently launched at the EU level (like the Recovery and Resilience Facility – RRF) to the reform process, taking on an active role in shaping Europe's future. The RRF has the potential to play a key role in keeping the social and economic costs of the COVID-19 crisis low and paving the way for successful structural change (greening of the economy, digitalization). A number of aspects that are becoming relevant now, as the EU support and financial aid programs are being rolled out, may also provide valuable input for the review and enhancement of the EU fiscal framework. These include the effectiveness of incentives (conditionality), the definition of eligible reform measures and investment (e.g. to address pressing issues like climate change and digitalization) and also mechanisms to facilitate more flexibility in the application of fiscal rules.