

PUBLIC FINANCE REPORT 2021–2026 FOR AUSTRIA (DECEMBER 2022) – KEY RESULTS AND RECOMMENDATIONS FROM THE FISCAL ADVISORY COUNCIL

Assessment of Austria’s fiscal situation from 2021 to 2026

The report was drawn up at a time when multiple global crises also hit Austria at full scale. For one thing, it remains highly uncertain how Russia’s war of aggression against Ukraine will evolve (duration of the war, sanctions, supply bottlenecks, gas embargo, etc.). For another, there is also a lot of uncertainty about global market prices, in particular for commodities and energy, and what the future holds in terms of the COVID-19 pandemic. This entails substantial risks to the forecast of public revenue and expenditure, which determine Austria’s medium-term fiscal and debt path. The fiscal forecast of the Fiscal Advisory Council is based on a no-policy-change assumption, i.e. no additional government spending or changes in revenue are assumed.

Our fall forecast draws on the latest economic outlook that the Austrian Institute of Economic Research (WIFO) released in early October 2022. Following a short boom from 2021 to mid-2022 on the back of pandemic-related catch-up effects, WIFO projects real economic growth to stagnate in 2023 due to manifold negative economic stimuli. With soaring commodity and energy prices fueling historically high inflation rates, the Austrian economy faces extraordinary challenges.

The anticipated path of key fiscal indicators is therefore driven by the high price increases, which (1) directly impact on individual expenditure and revenue categories, albeit in part with a time lag, and (2) have given rise to comprehensive discretionary measures to cushion the effects of high inflation. While, for instance, turnover tax receipts, intermediate consumption and interest expense promptly react to inflation shocks, it takes one year to one and a half years for price adjustments to pass through to other positions, above all, to revenues from payroll taxes or social security contributions, compensation of employees and pensions. All in all, the 2021/2022 inflation shock only has a small positive impact on the fiscal path in 2022, while worsening the budget balance in the subsequent years.

Austria’s discretionary fiscal policy focuses on anti-inflationary measures, the entry into force of the eco-social tax reform and measures ensuring a reliable supply of fossil fuels

Overall, discretionary measures continue to dominate the key fiscal variables in the 2022 to 2026 forecast horizon, despite the spurt in revenue at the beginning of the period under review and increasing social benefits up until end-2026. While measures mitigating the effects of the coronavirus pandemic are clearly decreasing, at a volume of EUR 8.0 billion in 2022, they still impact the budget balance considerably. In addition, a number of measures were taken to cushion the impact of exceptionally high inflation and to safeguard a reliable supply of fossil fuels. Together with the entry into force of the eco-social tax reform, these measures account for another EUR 14.4 billion in expenditure in 2022, up EUR 1.5 billion against 2021, when spending on discretionary measures was already very high. The year 2022, however, brought new additional challenges, and the composition of the discretionary measures has changed. Even though expenditure continues to grow at a fast rate, the budget balance improved overall thanks to the marked increase in government revenue on the back of the economic upswing, from –5.9% of GDP in 2021 to –3.2% of GDP in 2022. In 2023, the budget balance is expected to improve further, namely to –2.0% of GDP. Specifically, solid labor market conditions and nominal private consumption will compensate for the anticipated economic slowdown next year. In addition, temporary economic policy measures (such as COVID-19 mitigation measures or the need to set up a strategic gas reserve) will no longer be a factor. The collection of temporary solidarity contributions from fossil fuel companies on excess profits and a temporary cap on the market revenues for electricity generators will likewise play a role. What is set to weigh substantially on the improvement of the budget balance in 2023 are indexations under the

Austrian Income Tax Act and of both family and study allowance payments as well as the measures of the eco-social tax reform that are about to take effect. In the subsequent years, growth of social transfers in kind, military spending and interest payments will determine the medium-term budget balance that is expected to hover at -2.2% of GDP in 2026. In sum, the budget balance expressed as a percentage of GDP will improve owing to high nominal GDP (GDP denominator effect). Given that from 2023 onward, the output gap is expected to be virtually closed, the cyclical impact on the budget balance will disappear. As no one-off measures have been scheduled, the structural budget balance will equal the budget balance from 2023 onward. Looking at the size of the structural deficit (also following the deduction of the interest payment ratio, i.e. when considering the structural primary balance), we find that budget policy will remain strongly expansive throughout the forecast horizon.

Apart from the substantial budget deficits, it is above all the development of nominal GDP that will impact on the debt ratio. Owing to the high GDP denominator effect, the debt ratio starts to contract markedly in 2022, and the reduction is set to continue until the end of the forecast horizon (2021: 82.3% ; 2026: 73.2% of GDP).

2021: government revenue benefited from economic catch-up process; government expenditure once more driven up by COVID-19 pandemic

The economic recovery in 2021 clearly benefited general government revenues. While they had slumped because of the outbreak of the coronavirus pandemic in 2020, government revenues increased considerably in 2021 ($+9.4\%$ or by +EUR 17.5 billion year on year) thanks to the economic upswing. At EUR 203.2 billion (50.0% of GDP), 2021 revenues therefore clearly exceeded the pre-pandemic 2019 level again. All main revenue categories recorded strong growth in 2021, but it was particularly high for those taxes that had been weighed down by the pandemic in 2020: capital gains tax (+EUR 1.6 billion, $+63.5\%$), corporate income tax (+EUR 2.7 billion, $+35.3\%$), assessed income tax (+EUR 0.5 billion, $+10.4\%$), value-added tax (+EUR 2.5 billion, $+8.8\%$), payroll tax (+EUR 2.4 billion, $+8.4\%$) and social security contributions (+EUR 3.1 billion, $+5.2\%$).

Once again, government expenditure increased significantly, namely by 5.1% or EUR 11.1 billion in 2021 year on year; this is noteworthy given that 2020 growth had already amounted to as much as 11.9% . Overall government expenditure in 2021 totaled EUR 227.3 billion (56% of GDP). Further support measures to mitigate the effects of the pandemic in 2021 (including renewed lockdowns) caused spending to expand by EUR 2.1 billion to EUR 19.0 billion. While the expenditure for COVID-19-related short-time work decreased markedly from EUR 6.1 billion to EUR 3.1 billion, other spending went up considerably. Especially spending on fixed cost subsidies, compensation for lost turnover and the related bonus (paid out by the Austrian COVID-19 funding agency COFAG) grew markedly, from EUR 6.2 billion to EUR 8.5 billion, and that on health services from EUR 0.7 billion to EUR 4.1 billion. Having fallen because of the pandemic in 2020, demand for long-term care and health services picked up again in 2021, driving up social transfers in kind. By contrast, the expenditure for social benefits other than social transfers in kind increased only by a moderate 2.1% year on year. This is, above all, attributable to below-inflation pension increases (benchmark of 1.5%) and the one-off nature of the COVID-19 child benefit. In addition, persistently low interest rates once more reduced interest expense, namely by 10.8% or EUR 0.5 billion.

From 2022 onward, high inflation is affecting both revenue and expenditure growth

After the strong economic recovery, government revenue growth started to slow in mid-2022, as the economy started weakening. Nevertheless, government revenues in 2022 have been increasing by a marked 9.0% year on year. High inflation, higher wage settlements, solid private consumption and stable employment are also set to contribute to high revenue growth ($+7.3\%$) in 2023, which will, moreover, reflect additional revenues from the temporary solidarity contributions from the fossil fuel sector and the temporary cap on the market revenues for electricity generators. At the same time, from 2023

onward, structural measures are reducing revenues; they include, above all, measures of the second stage of the eco-social tax reform as well as the indexation to inflation under the Income Tax Act. By 2025, most remaining measures of the eco-social tax reform will have been implemented. Besides, temporary anti-inflationary measures will end completely and COVID-19-related measures will be phased out. As a result, government revenue will develop more or less in sync with nominal GDP in the subsequent years.

The budgetary effect that discretionary measures have on the expenditure side has been largely neutralized. For this reason, two factors primarily determine the year-on-year increase (+3.8%) in government expenditures in 2022: the automatic indexation of social benefits (pension expenditures and long-term care benefits) and rises in public sector wages. High inflation is only passing through to these expenditures with a time lag, whereas in the case of intermediate consumption an inflation spurt has expenditures soaring in the same year (+EUR 1.3 billion in 2022). In 2023, the main expenditure categories, such as pensions and compensation of employees, will likewise start to reflect the high inflation rates. This means that government expenditures will go up by 4.7% year on year in 2023, despite the noticeable decline in expenses (totaling EUR 5.2 billion) caused by the end of temporary pandemic-related and anti-inflationary measures. Over the medium term, while expenditure growth is set to contract again, it will remain at elevated levels in some areas (e.g. social benefits in kind, in particular health and long-term care, as well as gross capital formation).

Compared with our assessment of the budget path in our fall forecast, the Ministry of Finance is slightly more pessimistic in the short term, but clearly more optimistic in the medium term

The draft budgetary plan for 2023 and the strategy report for 2023 to 2026 was published by the Federal Ministry of Finance (BMF) in October 2022. For 2022 and 2023, the BMF's draft budget assumes general government balances of -3.5% and -2.9% of GDP, and the strategy report envisages a steady further improvement (2026: -1.6% of GDP). The Fiscal Advisory Council's fall forecast is comparatively optimistic, projecting the general government balance to come to -3.2% of GDP in 2022 and to -2.0% in 2023. For the years 2022 and 2023, the two forecasts primarily differ in the assessments of revenue figures, above all of indirect taxes. In contrast to the BMF's draft plan, the Fiscal Advisory Council's fall forecast already takes into account the additional revenue that is to result from the temporary solidarity contributions of the fossil fuel sector (which were announced in mid-November 2022). This, however, amplifies the deviation in 2023. Moreover, compared with the BMF, the Fiscal Advisory Council assumed the expenditure for both years, and in particular for 2023, to be lower. From 2024, the assessments reverse, as the Fiscal Advisory Council expects expenditure to rise more strongly and revenue to grow less strongly until end-2026 than the BMF.

Even though its fiscal position has deteriorated because of recent crises, Austria is set to meet both Maastricht criteria from 2023 onward

After the general government deficit reached historical highs in 2020 (8.0% of GDP) and 2021 (5.9% of GDP), the Maastricht balance is projected to clearly remain in negative territory in 2022 (-3.2% of GDP) according to the Fiscal Advisory Council's fall forecast. The breach of the deficit ceiling of 3% of GDP will no longer be "excessive," however. According to our fall forecast, Austria will meet both Maastricht criteria (fiscal balance and reduction of the general government debt ratio) starting in 2023. The Maastricht deficit will gradually contract to 1.9% of GDP in 2024, thanks to the temporary additional revenue resulting from the solidarity contributions from the fossil fuel sector in 2023 and 2024. After that, the Maastricht deficit will widen again in the subsequent years, to more than 2% of GDP. The debt ratio will be gradually reduced, to reach 73.2% of GDP in 2026. In light of the multiple concurrent crises (pandemic, war in Ukraine, high inflation), the European Commission is likely to stay the course and not launch excessive deficit procedures in any EU member state until end-2023.

Given the activation of the general escape clause, which allows deviations from the structural budget requirements imposed by the Stability and Growth Pact for 2020 to 2023, we continue to refrain from a quantitative assessment of related deviations. Upon the deactivation of the general escape clause at end-2023, Austria will deviate markedly from the medium-term objective (MTO) of a maximum structural deficit of 0.5% of GDP and from the required adjustment path toward the MTO based on the Fiscal Advisory Council's fall forecast. It remains to be seen what potential changes to the fiscal rules at the EU level could imply. What is currently under discussion is using the net primary expenditure aggregate as the key indicator to achieve sustainable debt-to-GDP ratios.

In spite of large-scale breaches in 2021, 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 2023 – also in the context of national fiscal rules – and hence no determination of breaches that might usually entail financial sanctions. As a result, breaches identified at different levels of government in 2021 and any potential breaches until end-2023 will not lead to financial sanctions. Conducting an ex ante assessment of the subsequent years (2024 to 2026) makes sense only once the general escape clause has been deactivated, the EU has put reforms on the table and Austria's 2012 National Stability Pact has been adjusted accordingly.

Recommendations by the Fiscal Advisory Council on Austria's budget policy for 2023

To open up fiscal space in the medium term, expansionary fiscal policy needs to be tightened again while considering the business cycle

Background: Austria's fiscal space will be narrowing over the short to medium term because the economic environment is deteriorating and because the pandemic and high inflation have made it necessary to adopt temporary discretionary support measures designed to mitigate the consequences of these multiple crises for households and businesses. What is more, demographic change, low real economic growth and rising interest expenses are increasingly putting strain on public finances over the medium term. This will result in deficits, some of them substantial, which will amount to over 2% of GDP in the medium term according to the Fiscal Advisory Council's fall forecast. Austria's debt ratio, which has been strongly elevated because of crisis measures, is moderating against the background of high nominal economic growth driven by inflation. It will, however, remain clearly above the Maastricht ceiling of 60% of GDP and above pre-crisis levels, reaching 72.6% of GDP in 2026 (2019: 70.6% of GDP).

Recommendations:

- To regain some fiscal space, it is crucial that expansionary fiscal policy be tightened again taking into account the business cycle and that temporary support measures be phased out as planned. In the view of the Fiscal Advisory Council, the medium-term budgetary objectives the federal government has set out in its fiscal strategy report cannot be reached without additional measures. The federal government should therefore present a holistic concept for the long-term stabilization of public finances, which needs to include ways to fund crisis measures.
- Where temporary support is granted to mitigate the effects of inflation, policymakers need to keep in mind that this is merely an interim option to bridge financing gaps until real purchasing power is restored through the usual mechanisms (e.g. wage increases, indexation of social benefits). The current inflation shock does not seem to necessitate additional general measures, especially for households, as automatic indexation will be higher than inflation from 2023 and 2024 onward. Some groups that are particularly affected and at risk of poverty may, however, need increased and better targeted support measures.
- A scientific evaluation of how effective, targeted and adequate revenue- and expenditure-side support measures are (in terms of addressing the underlying shock) should contribute to an effective and targeted use of public funds. Such an evaluation, which is seen as a prerequisite and basis for deciding on any new measures, would require the creation of an adequate data basis at household level.
- Also, the government should pay closer attention to the interplay between monetary and fiscal policy in order to minimize (1) avoidable counterproductive effects the fiscal expansion might have on the ECB's monetary policy objectives and (2) counterproductive effects the monetary policy tightening might have on fiscal targets.

Investments in the future and structural reforms to safeguard long-term fiscal sustainability

Background: Our fiscal sustainability report of September 2021 found that government expenditure on health and long-term care services is set to increase particularly strongly in the long run, namely from 7.1% and 1.2% of GDP in 2019 to 9.9% and 3.1% of GDP in 2070. The comparatively moderate growth of pension expenditure (from 14.0% of GDP to 15.2% of GDP in the same period) is affecting the replacement rate of pension payouts and is very sensitive in view of the extraordinary increases in pension payouts repeatedly recorded in the past. In light of the permanent effects of the current fiscal policy (inflation

indexation of the Austrian Income Tax Act, value adjustment of social benefits), the findings of the Fiscal Advisory Council's fiscal sustainability report regarding the long-term sustainability gap remain virtually unchanged. We had already by default factored in an acceleration of revenue and expenditure growth in the long-term projections.

Investment and structural reform can contribute to sustainable economic growth and hence strengthen fiscal sustainability. Inaction in addressing climate change, on the other hand, will clearly drive up follow-up costs. Ensuring fiscal sustainability does not preclude visible progress toward a green, digital, inclusive and resilient economy. The Fiscal Advisory Council therefore welcomes initiatives such as the federal government's climate and green transition initiative and the Municipal Investment Act 2023.

Recommendations:

- The green and digital transformation should be actively and resolutely supported with a balanced mix of measures (e.g. regulatory and fiscal measures) which provide incentives for private and public investment. This mix should include implementing a targeted education and qualification initiative to address both upskilling (e.g. innovation capacity, entrepreneurship, relevant vocational training, green and digital qualifications) and the imminent acute shortage of skilled labor.
- To allow an efficient use of resources for climate protection, policymakers should:
 - gather all the pertinent facts (defined target path, identification of the investment gap, marginal abatement cost curve);
 - evaluate the cost effectiveness of individual technologies;
 - establish an overall strategy by involving the social partners and improving coordination across the different levels of government with a view to implementing a balanced mix of measures and incentives;
 - undertake some reallocation within the budget to find necessary budget funds;
 - coordinate efforts toward a green and sustainable orientation of public finances.
- Structural reforms need to be implemented to put a brake on spending growth. Above all, efficiency gains need to be generated, in particular by disentangling responsibilities and financing across different levels of government. Also, to preserve sustainable financing for the pension system, the government should refrain from making extraordinary adjustments to pensions.
- Increasing the frequency of general government spending reviews, especially in the areas of health, long-term care, subsidization, climate policy and education, could raise transparency and help identify both issues that require action and options for addressing them.

Results-oriented, swift negotiations on the revenue sharing agreement are an opportunity to establish strengthened coordination and steering mechanisms across all levels of government

Background: Funding for regional and local governments is largely dependent on financing flows across the different levels of government. These financing flows, in turn, depend strongly on the institutional and legal situation within the Republic of Austria (division of responsibilities, tax powers, revenue sharing rules). The Revenue Sharing Act (Finanzausgleichsgesetz – FAG) 2017–2021, which will remain in force for two additional years, will continue to provide the financial framework for the different levels of government in 2023. The revenue sharing agreement decided on at the time also contained elements that were designed to trigger structural reforms. Steps to prepare a federal state reform, a benchmarking model for assessing efficiency in areas within public responsibility or the reform of the property tax were agreed. Moreover, it was agreed to promote a more task-based allocation of funding in the Revenue Sharing Act on the basis of pilot projects (e.g. in the area of elementary and lower secondary education). Although first steps toward disentangling competencies have been taken, important areas like the

hospital and education sectors have yet to be addressed. From the Fiscal Advisory Council's perspective, the government has to date failed to implement important structural reforms: aligning responsibilities with the power to tax and the power to spend, establishing fiscal equivalence (beneficiaries of a public good are responsible for financing this public good) and promoting a more task-based allocation of funding.

Recommendations:

- The negotiations on the new revenue sharing agreement should be conducted swiftly and focus on results, in particular with regard to raising transparency, efficiency, coordination and steering within a federal state. These results need to include the following:
 - disentangling financing flows and tasks across the different levels of government;
 - promoting a more task-based allocation of funding, especially for social transfers in kind (e.g. child care, long-term care);
 - strengthening the regional and local governments' tax autonomy and thus their responsibility for financing public services subject to a reform of tasks;
 - establishing a mechanism for distributing and financing the fiscal burden or "investment gap" arising from the green and digital transformation;
 - developing benchmarks.
- An overall subsidization strategy for the general government needs to be established. Above all, Austria needs to avoid unintentional multiple subsidies through different levels of government and conflicting incentives of measures – both in terms of the measures as such and the interplay of different levels of government (e.g. electricity price cap). The following aspects are of particular importance:
 - design of subsidies: subsidies need to effectively target those who really need them
 - transparency database: identifying potential for further development; data analysis and conclusions based thereon

Institutional mechanisms for raising the transparency, effectiveness and impact orientation of budgets

Background: Over the last few years, the federal government has introduced several mechanisms to manage its budgets in a more transparent and effective manner, focusing on both targets and impacts: impact orientation within the framework of the 2009 reform of the legal framework for budgeting, including gender budgeting, spending reviews and, most recently, green budgeting. These mechanisms are meant to improve fiscal policy by paying closer attention to the intended and achieved impact of measures rather than focusing primarily on the input side. Applying such mechanisms can raise the transparency and effectiveness of the budget process and the accountability of political decision-makers. Currently, however, the government is not making use of the full benefits these mechanisms potentially afford.

Recommendations:

- Mechanisms to raise the transparency, effectiveness and impact orientation of budget management should be coordinated more effectively across ministries and different levels of government.
- The individual mechanisms must be brought into closer alignment to avoid uncoordinated and inefficient parallel structures, overlap and redundancies.
- The quality of the impact assessment within the framework of the regulatory impact assessment for draft legislation and of the compulsory ex post evaluation must be safeguarded and developed further.

- It should be possible to make better use of the potential offered by gender budgeting by more closely considering relevant operational targets as well as suitable measures and by ensuring better coordination across different ministries.

New spending rule in line with the European Commission's proposal should be implemented constructively and quickly; structural budget balance should be retained as a key figure for orientation and analysis

Background: Based on the European Commission's first initiative of February 2020 to reform the Stability and Growth Pact, which has been discussed with national institutions, stakeholders and EU institutions in the meantime, the European Commission submitted a new proposal in November 2022. The most important elements of the current reform proposal are simplifying the fiscal rules and promoting more fiscal rules ownership at the level of the individual member states. Differentiated, medium-term national fiscal structure plans are to set out upper limits for budget paths on the basis of a single operative indicator, i.e. net primary expenditure. Fiscal structure plans are supposed to offer more flexibility for growth-enhancing reforms and investments, especially in the area of green and digital transformation. A more realistic, slower debt reduction is to be backed by a stronger sanctioning mechanism. Based on the proposal, the structural budget balance, which has served as a key figure for fiscal policy orientation and analysis in the past, will no longer be considered. The proposal increases the European Commission's discretion in determining the reference path and in assessing and recognizing reforms and investments. It also opens up some room for negotiation between the European Commission and member states regarding the final adjustment path. The proposal is rather vague and non-committal regarding the role of independent fiscal institutions (IFIs).

Recommendations:

- Austria's federal government should actively and constructively contribute to ensuring that the process of reforming the EU fiscal framework is swiftly brought to a conclusion – in the current phase in which the general escape clause still applies – which will pave the way for making the necessary adjustments to the national fiscal framework. Speedy decisions toward simplifying the framework and laying down country-specific, steering-relevant rules are a cornerstone for sustainable fiscal policy and adequate surveillance.
- Placing greater weight on medium-term spending as proposed by the European Commission is in line with previous recommendations by the Fiscal Advisory Council, as this contributes to an improved steering effect and a stronger medium-term orientation. This does not preclude the continued consideration of the structural budget balance as a key figure for fiscal policy orientation and analysis in the interest of a sustainable fiscal framework that adequately takes into account the requirements of the business cycle.
- The Fiscal Advisory Council supports the idea of stronger coordination across national fiscal policies as proposed by the European Commission.
- The involvement of national independent fiscal institutions in fleshing out and finalizing the fiscal rules reform should be resolutely promoted with a view to supporting the parliamentary decision-making process. In the context of the surveillance process, the Fiscal Advisory Council should be involved, first and foremost, in the ex ante and ex post assessment of fiscal structure plans.