FISCAL RULES COMPLIANCE REPORT 2020-2025 FOR AUSTRIA (JUNE 2021) - EXECUTIVE SUMMARY AND RECOMMENDATIONS

Assessment of Austria's fiscal situation from 2021 to 2025

Austria's medium-term fiscal and debt paths continue to be severely affected by the substantial economic and social impact of the COVID-19 pandemic, and any assessment remains fraught with high uncertainty. The Austrian economy slumped by 6.6% in real terms in 2020 compared to the previous year and has been recovering slowly in 2021 so far. Owing to temporary closures of retail stores and close contact service providers as well as postponed and gradual openings in the hospitality and events sector, economic activity is set to pick up momentum only from summer 2021 onward, which means that we will see much of the recovery and catching-up process only in 2022. Against this backdrop, the Austrian Institute of Economic Research (WIFO) projects real GDP growth to be 1.5% and 4.7% in 2021 and 2022, respectively. This forecast, which took into account the April 2021 lockdown, provides the basis for the Fiscal Advisory Council's forecast. In the years after 2022, economic activity is expected to expand at a moderate pace, with real GDP growth remaining below 2%.

New medium-term fiscal forecast expects sustained high budget deficit in 2021 and gradual deficit reduction until 2025

Given the current macroeconomic conditions, the Fiscal Advisory Council projects Austria's budget deficit to amount to 7.6% of GDP in 2021 (2020: 8.9% of GDP). This deficit mirrors continued high government spending on measures taken to cope with the COVID-19 pandemic and its extensive consequences. The calculations of the 2021 Maastricht deficit take into account discretionary – mostly expenditure-side – measures in the amount of 6% of GDP. They include the extension and adaptation of existing measures and the introduction of new support measures (e.g. short-time work, fixed cost grants, compensation for losses as well as turnover loss bonuses and "corona bonuses" for health sector employees). Starting from spring 2021, the Fiscal Advisory Council prepares a medium-term fiscal forecast to evaluate the national medium-term fiscal estimates on the basis of the Austrian stability program. The first medium-term forecast covers the years 2022 to 2025. Over this period, the budget deficit is expected to shrink from 3.6% of GDP to 0.9% of GDP (cutoff date: May 26, 2021). This forecast rests on the no-policy-change assumption and on the assumption that the majority of COVID-19 support measures expires early in the second half of 2021.

Discretionary policies to counter pandemic effects continue to determine government revenues and expenditure well into 2022

The Fiscal Advisory Council's spring forecast expects government revenues to recover moderately initially (2021: +3.0% to EUR 189.8 billion or 49.2% of GDP). In 2022 and 2023, the pace of increase is set to pick up (+5.4% and +4.0%), so that in 2022, government revenues should reach EUR 200.0 billion, exceeding the pre-crisis level of EUR 195.5 billion recorded in 2019. The revenue ratio is forecast to remain stable at just over 49% of GDP in the medium term. 2020 saw a EUR 11.3 billion drop in revenues, which affected all revenue categories because of the decline in the tax bases owing to the prevailing macroeconomic conditions and discretionary measures. We expect that after this historic slump, we will see rebound effects and the gradual inflow of deferred taxes, which may vary over time, however. The forecast assumes that assessed taxes will recover only slowly, especially compared with income taxes on wages. This is due to the measures in place (such as accelerated depreciation, special aid for cafes, bars and restaurants) and in line with past experience (e.g. after the financial crisis of 2008). Indirect taxes, on the other hand, are expected to increase faster already in 2022, in line with buoyant private consumption. In addition, revenues from indirect taxes are expected to rise in the medium term also on the back of measures adopted with the aim of greening the tax system. Social security contributions are recorded on an accrual basis according to ESA 2010, i.e. as total claims (minus irrecoverable claims, which are written off immediately), which gradually feed through to the cash balance as contributions are being paid.

We expect government expenditure to increase further – by 0.7% to EUR 219.0 billion – in 2021 due to the ongoing health crisis. Even though a decline was projected in fall 2020, discretionary spending in response to the pandemic will continue throughout most of 2021. Compared with 2020, pandemic-related government expenditure will decrease by only EUR 3.6 billion to EUR 14.6 billion in 2021; only in 2022 will there be a significant drop by EUR 12.6 billion to EUR 2.1 billion. The latter will be reflected also in overall government spending, which is projected to fall by EUR 4.9 billion or 2.2% in 2022. Over the medium term, we expect expenditure growth of below 2% (based on the no-policy-change assumption, which implies a decreasing impact of discretionary measures). The expenditure ratio is projected to move toward the 50% mark in the medium term, following the extremely high value – 57.8% – recorded for 2020 and 2021. The path of overall government expenditure is very much driven by subsidies. This category covers the substantial aid granted through the Austrian COVID-19 funding agency COFAG (fixed cost grants, compensation for losses, turnover loss bonus) as well as short-time work schemes. Furthermore, monetary social benefits have a major effect on overall government expenditure; such benefits include benefits for unemployed persons, whose number is projected to be still some 20,000 above the pre-crisis level of 2019, as well as spending under the hardship fund and the "corona bonus" for pensioners.

Our current forecast for the first time includes measures under the national recovery and resilience plan from 2021 onward. The bulk of these measures are funded through the EU's Recovery and Resilience Facility. From today's perspective, these measures will add to the deficit (EUR 0.6 billion) only in 2025, as payments from the national recovery and resilience plan will not be matched by revenues in that year.

Fiscal Advisory Council forecast clearly more optimistic about 2021–2024 fiscal path than current stability program

The government's stability program of April 2021 sees consistently higher budget deficits for the period 2021 to 2024 than the medium-term fiscal path projected by the Fiscal Advisory Council this spring. The gap between the two forecasts is 0.8% of GDP in each year except for 2023, when the general government deficit according to the stability program is 0.3% higher than the Fiscal Advisory Council's forecast. The reason for this difference is that we project a considerably stronger increase in general government revenues (faster recovery of assessed personal and corporate income taxes, higher increase in VAT revenues over the medium term). For the expenditure side, the path looks similar in both forecasts. There are some larger gaps in individual categories; in particular, the Fiscal Advisory Council sees higher spending on subsidies (funds paid out by COFAG) and a stronger rebound effect in 2022 and 2023 toward trend growth for health expenditure on intermediate consumption and for social transfers in kind.

Continued reduction of government debt ratio after historical high in 2021

Austria's general government debt ratio is set to rise further in 2021, climbing by 4.8 percentage points to 88.7% of GDP (2020: +13.4 percentage points to 83.9% of GDP). After this historical high, the debt ratio is expected to decline continuously to reach 83.8% in 2025. This drop is primarily attributable to the "denominator effect," which will reduce the debt ratio by an average 3.2 percentage points p.a. in the years 2021 to 2025, whereas stock-flow adjustments will contribute only marginally in 2021 and 2022, according to current data. Finally, we expect the interest expenditure ratio to decrease until 2024 and a significant reduction of primary deficits over the forecast horizon.

No sanctions for clear failure to meet Maastricht criteria 2020 to 2022

The European Commission and the Ecofin Council have agreed that as long as the "general escape clause" is activated (which, according to current information, will be the case until 2022), no procedural steps will be triggered if Member States do not comply with the Maastricht criteria because of the extremely high uncertainty about the macroeconomic and fiscal impact of the COVID-19 pandemic. According to the Fiscal Advisory Council's spring forecast, Austria will clearly breach the deficit threshold of 3% of GDP over this period. Likewise, the government debt ratio will not be in line with the requirements of the EU's Stability and Growth Pact (SGP). From 2023 to 2025, the general government deficit and the government debt ratio are set to decline further. In fact, we expect Austria to remain below the deficit criterion from 2023 onward, while the projected debt path currently suggests that compliance with the debt rule will be missed by a small margin in 2023 to 2025.

The activation of the "general escape clause" allows Member States to deviate from their structural budget targets from 2020 to 2022; moreover, neither the European Commission nor the Fiscal Advisory Council will provide numerical evaluations for this period. From 2023, when the "general escape clause" no longer applies, our forecast shows that the budget is set to move toward a sustained path in line with SGP requirements (based on a no-policy-change assumption). Moreover, the output gap and the structural budget balance should be interpreted with particular caution because during the current health crisis, the application of methods normally used for estimating these indicators (business cycle smoothing) result in implausible revisions.

As long as the "general escape clause" remains activated, the Fiscal Advisory Council continues to refrain from conducting ex ante evaluations of the national fiscal rules under the Austrian Stability Pact (2012 ÖStP), also because the preparation of subsectoral budget plans is subject to particular uncertainty and the current data are volatile.

Fiscal Advisory Council recommendations on Austria's 2021 budget policy

Cautiously proactive return to sustainable fiscal policies after the pandemic

Background: According to the Fiscal Advisory Council's spring forecast, Austria will record a pandemic-induced historically high government debt ratio of 88.7% of GDP in 2021. While interest rates are still very low, providing for very favorable funding conditions also for Austria, high government debt quickly drives up interest expenses once interest rates rise; eventually, higher primary surpluses are needed to stabilize the debt ratio. Even if the interest-growth differentials were to remain negative, reducing the debt ratio without additional measures would be successful only in the long run. In contrast to the situation after the economic and financial crisis of 2009, the resolution of nationalized banks[1] can now contribute only little to cutting debt.

Recommendations:

- The COVID-19 pandemic has made it necessary for governments to make extensive use of stability-enhancing policies in order to cushion its impact on the health system, society and the economy. In order to preserve government's room for maneuver for such major interventions in future crises, it is crucial that in the medium to long term, the government debt ratio be reduced to a level in compliance with the requirements of the EU fiscal framework.
- As soon as the immediate social and economic consequences of the pandemic have been overcome, the government should switch from the current crisis mode to pushing ahead with implementing the measures to support the economic upswing and strengthen the domestic economy's resilience and to gradually returning to a path of sustainable public finances.
- The exit from direct government support measures must be well prepared and consistent with the business cycle. This will help prevent setbacks to economic growth and build up fiscal risk buffers in

[1] HETA, KA-Finanz AG and immigon portfolioabbau ag; from 2021, only KA-Finanz AG has liabilities.

the medium to long term.

- Timing is crucial: the regime change should take place in a differentiated way that takes into account individual measures, their effectiveness and objectives.

Implementing structural reforms to safeguard highly effective systems of the welfare state and sustainable public finances

Background: The European Commission's 2021 Ageing Report predicts that age-related expenditure will continue to rise in Austria. According to the report, public expenditure on health and care services will increase from 6.9% and 1.8% of GDP as measured in 2019, respectively, to 8.0% and 3.2% of GDP in 2050. Importantly, these projections were made before the onset of the COVID-19 pandemic, which will have potential long-term implications for the domestic health and long-term care systems. In addition to the expected increases in costs, there are other challenges for the sustainable funding of long-term care in Austria, i.e. the discontinuation of the temporary federal subsidies to the regional and local governments (long-term care fund) at the end of 2021 and the fragmentation of responsibilities between the different levels of government.

Taking the recommendations by the Fiscal Advisory Council of December 2020 further, adjustments in particular in those areas where there is a strategic and structural need for reform (e.g. the tax system, subsidies, pensions, long-term care) should be integrated into an overall strategy. Such a strategy should be guided by economic policy objectives, such as raising the employment ratio, as well as sustainable funding and a clear division of responsibilities.

Recommendations:

- Structural reforms (in particular in health care, long-term care, the pension system and education) need to be prepared, launched and implemented to safeguard effective systems of the welfare states and sustainable public finances, irrespective of the current crisis mode and preparations for measures to support a sustained upswing.

- The expected significant increase in expenditure on long-term care, which may be even higher because of the potential long-term effects of the COVID-19 pandemic, requires that the Austrian long-term care system be designed and funded in a sustainable manner. The Federal Ministry for Social Affairs, Health, Care and Consumer Protection has already taken steps in this direction.

- Responsibilities that concern different levels of government in Austria, such as health care and long-term care, should be able to benefit from efficiency gains achieved through aligning responsibilities more strongly with the power to tax and the power to spend at all levels of government and disentangling intergovernmental transfers. A transparent overview of the status quo is a prerequisite for achieving this goal.

Accepting ecological and digital challenges and choosing the adequate policy mix

Background: The political agreement on the next long-term EU budget included not only an outline of how the implementation of the European Commission's current priorities, in particular the "Green Deal" and the EU's digitalization strategy, will be funded but also established the NextGenerationEU (NGEU) program. NGEU provides temporary funding for measures to cushion the economic and social impact of the COVID-19 pandemic and supports the economic recovery and the ecological and digital transformation process. It has an overall volume of EUR 750 billion, which will be raised through the issuance of EU bonds. At the heart of the NGEU, the Recovery and Resilience Facility (RRF) will make available loans (EUR 360.0 billion) and grants (EUR 312.5 billion) to support investments and reforms undertaken by the member states. RRF funding will be subject to special rules on conditionality aimed at supporting the achievement of important social and environmental objectives. In addition, failure to meet internationally agreed climate targets will carry financial sanctions, which lends an additional fiscal dimension to the reduction of greenhouse gas emissions. Given these challenges, public and private investments play a decisive role.

Recommendations:

- The funds made available through newly established instruments like the Recovery and Resilience Facility should be called off and used efficiently, given the significant role of public and private investments made to tackle critical challenges like climate change and digital transformation but also to address potential learning gaps caused by the pandemic or digitalization (e.g. providing for equal opportunities in terms of IT infrastructures and competences).
- Continuing with the ecological and socially just ("eco-social") tax reform in the context of the planned pricing of carbon emissions while factoring in compensation payments (in order to avoid negative distributional effects) should contribute substantially to reducing greenhouse gas emissions and meeting agreed targets. Putting even more emphasis on ecological elements could generate desired environmental effects (i.e. reduction of emissions), but also fiscal effects (like avoiding penalties for failing to meet CO_2 targets). Furthermore, a balanced mix of instruments and incentives (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.
- The EU funds should be used to provide important impetus for achieving the bundle of targets and promoting positive cultural change toward digitalization, greening, knowledge building and social balance (Just Transition Mechanism). In addition, public and private investment as well as incentives for cutting carbon emissions reduce the scope and danger of potential penalties for noncompliance with internationally agreed climate targets.
- Priority should be given to measures aimed at enhancing Austria's economic, institutional and social resilience, strengthening the domestic economy's growth potential and creating new jobs (e.g. digital and green investments, investment in local public transport, enhancing and strengthening businesses' capital base, promoting the creation of new businesses, additional funds for education, etc.).
- Information about the funds available, applications and disbursement of funds provided on a regular basis and in a timely and transparent manner will be crucial for monitoring the implementation of the Austrian recovery and resilience plan.
- When approving and granting funds, efforts should be made to address and avoid deadweight effects and elements that may distort competition.

Using current conditions (no numerical evaluation of rules compliance) to develop further and optimize the Austrian fiscal framework (2012 ÖStP)

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 the national fiscal rules. The issues we identified concern, in particular, 1) the complexity of the national framework, 2) the rules' small steering effect, 3) the operationalization and application of the "general escape clause" and the regime change after its deactivation and 4) the validity of data.

Recommendations:

- The time during which the "general escape clause" is activated should be used to reflect on the experience and insights gained from applying the national fiscal rules and prepare proposals for their refinement. This will not only help inform discussions but also support the return to sustainable fiscal and debt paths at all subsectoral levels following the deactivation of the “general escape clause” (which we expect to be from 2023) by providing for a simpler rules framework and improved steering elements.

- An in-depth reform should be launched only after reforms have been agreed at the EU level in order to ensure consistency between national and EU fiscal rules. Against this backdrop, a sequential approach seems advisable: a clarification and definition of processes for the immediate application of the ÖStP should be followed by a more comprehensive reform of the framework. The following aspects could help improve steering effects and monitoring processes sooner:

    - Adjusting the current practice of “freezing” control account balances only after they have been adopted by the Austrian Coordination Committee (ÖKK). Recommendations by the Fiscal Advisory Council refer to budget figures reported by Statistics Austria, which has the legal mandate to provide the necessary data. Later modifications may obstruct and undermine monitoring. Against this backdrop, we recommend that rules be established that ensure an appropriate time schedule (which allows the correction of balance outcomes, the consideration of new interpretations, an ex post evaluation of rules compliance) and set out the mandates of all bodies involved.

    - Adjusting the existing (rigid) debt path to facilitate debt reduction by the individual levels of government based on how the level and distribution of debt have changed under the new conditions (e.g. raising the debt path by the size of the COVID-19 level effect, also taking into account the subsectoral composition of debt as at end-2020).

    - Launching a trial run for a simplified expenditure rule that refers to limiting the growth of a simple expenditure aggregate that can be monitored on an ongoing basis.

Actively contributing to developing further the EU fiscal framework and resolving issues of conflicting objectives

Background: The European Commission’s evaluation of the EU fiscal framework has revealed both the strengths (e.g. reduction in government debt) and weaknesses (in particular the complexity of the rules, occasional procyclicality of fiscal policies) of the current system. Applying the existing fiscal rules while at the same time supporting a sustainable upswing after the current health crisis will be an additional challenge. Moreover, the system entails a fundamental conflict between rules-based fiscal policies to ensure fiscal discipline on the one hand and a flexibilization of fiscal requirements without losing credibility and without abandoning the target of public finances that are balanced over the business cycle on the other.

Recommendations:

- The Austrian federal government should actively engage in the upcoming reform process and urge that the EU-wide debate on the enhancement and reform of the EU fiscal framework addresses today’s unprecedented challenges (overcoming the COVID-19 pandemic, fighting climate change, digital transformation). Special attention should be paid to resolving issues that entail conflicting objectives to achieve a balance between fiscal discipline and flexibilization in the framework of a rules-based fiscal policy.

- Given that the reform of the EU fiscal framework is now taking place under completely new conditions, the Fiscal Advisory Council considers the following aspects to be of particular relevance:

    - Conflicts in defining a fiscal policy anchor: The historically deep economic slump and the support and stimulus measures went hand in hand with an increase in public deficits and government debt. At the moment, consistently low interest payments and the low interest rate environment provide for fiscal space and the opportunity to carry out investment projects to support the economic upswing and, in particular, to create an infrastructure capital stock (while addressing economic priorities like digitalization and green investments) which can generate long-term macroeconomic yields. These goals must not interfere with sustainable fiscal policies, however.

- Reliability of fiscal rules in times of crisis, in particular when applying business cycle smoothing:

    - If we apply the methods normally used for estimating and projecting potential output (business cycle smoothing), the economic slump caused by the current health crisis will lead to downward revisions of potential output and, as a result, upward revisions of the output gap, also for the past few years; this represents a statistical artefact rather than indicating an overheating of the economy. For this reason, the output gap and the structural balance should be interpreted with particular caution.

    - The establishment of an expenditure rule as an operational tool to achieve an overriding debt target allows more flexibility, but at the expense of simplicity. Using specific expenditure aggregates makes it possible to implement different fiscal targets, which, however, would imply an increasing neglect of expenditure flows that can be monitored.

- In order to actively contribute to the reform process, we recommend that more in-depth discussions of all stakeholders take place to achieve more clarity about the effectiveness of rules-based fiscal policies under the new conditions.