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Fiscal Policy Tools of Compensating for Inflation

Following the recent acceleration of inflation, a number of fiscal policy measures to dampen the impact of higher consumer prices have been put forward for discussion in Austria. In principle, the means of fiscal policy are limited as they can only cushion the effects of inflation without addressing its drivers. Fiscal measures to neutralise a bout of inflation are potentially costly and may take pressure off policymakers to squarely tackle the root causes of price hikes. Priority should therefore be given to policy action targeting the origins rather than the symptoms of inflation.

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Since the end of 2007, inflation in Europe has accelerated from its medium-term trend. Above-average price increases have been registered also in Austria. Against this background, measures to combat inflation have become the focus of the economic policy debate. In this regard, many eyes are set also on possible contributions from the fiscal side.

Inflation is considered a policy problem because of its redistributive effects as well as of implicit negative allocation effects through a weakening of price signals (*Pätzold,* 2008). The distributional dimension of inflation derives from the fact that it erodes the real value of public transfers to households and from the loss in real purchasing power hitting in particular the recipients of low market and transfer incomes who use all or most of their disposable income for consumption.

The public authorities, by adjusting revenues and expenditure, can influence only the distributional effects of inflation. The scope for action of fiscal policy is confined to (partially) offsetting the inflation-induced distributional effects. Budgetary measures can only neutralise entirely or in part the loss in purchasing power resulting from the increase in the overall price level, thereby addressing the symptoms of inflation. Fiscal policy cannot, however, remove the underlying causes of inflation. Action in that regard would have to tackle factors like barriers to competition[1], notably in areas of low technical and organisational innovation, or speculative overshooting on the markets concerned. Unlike budgetary measures, such action would require not only a disaggregated investigation into price hikes for particular goods and services, but also a thorough analysis of the factors driving prices up on these markets.

One fiscal measure that targets not the results but one of the causes of higher inflation is the introduction of a tax on speculative gains: a tax on financial transactions on markets where prices are partly driven by speculation (such as with financial derivatives for food and raw materials) is supposed to rein in such speculative transactions, such that prices are stabilised and the speculative element is reduced. Since it would be difficult to introduce such a tax on speculative gains via a go-it-alone at the national level (see also *Schulmeister – Schratzenstaller – Picek,* 2008), it will not be considered further in the present context which focuses on policy instruments at the disposal of national governments.

[1] For reference, see *Böheim* (2008), in this issue.

General considerations

Fiscal policy targets and challenges

Fiscal policy measures to compensate for inflation are supposed to offset the inflation-induced loss of purchasing power of private households. This is of particular importance for the lower income brackets which suffer most from a general increase in the price level due to their above-average propensity to consume. Low-income earners are all the more vulnerable if price hikes are concentrated on goods and services which claim a large share in this group's household budgets, such as food or heating items. In this case, ad-hoc fiscal measures serve a clear social policy purpose. It should nevertheless be ensured that such measures will not produce side-effects that violate other policy goals such as environmental concerns.

The ability to meet social targets and the compatibility with other policy goals are thus criteria for the assessment of particular fiscal policy measures to counter the effects of higher inflation. If price hikes are concentrated on certain sectoral markets it is also important to consider the effectiveness of the measures envisaged, i.e., to what extent they can actually provide relief on these markets. In Austria, more than half of the inflation observed in recent months is explained by food and energy price hikes. Since consumption taxes are to some extent harmonised within the EU, measures in this area also need to comply with European legislation.

Specific policy approaches

In order to counter the loss of purchasing power of private households caused by inflation, fiscal policy may take measures either on the revenue or the expenditure side of the budget.

On the *revenue side*, the government may respond to (the acceleration of) inflation by modifying *taxes, social security contributions* or *public charges*. Within the category of taxes, relief measures may be specific or unspecific.

Specific tax relief measures are deliberately targeted to the cushioning of price increases on particular sectoral markets. They include, for example, cuts in excise taxes that are levied on the purchase or use of certain goods and services which are affected by the price hikes, like the mineral oil tax or the reduced VAT rate. Also the neutralisation of fiscal drag for the income tax (see box) represents a specific tax compensation measure.

Unspecific general cuts in taxes or social contributions are intended to foster households' purchasing power. Thus, a cut in income tax or VAT rates as well as in social security contributions would fall into this category. Likewise, reductions in public charges to be paid for the consumption of certain public services represent unspecific measures with a view to strengthening private purchasing power.

On the *expenditure side*, adjustments to *transfer payments* play a major role. Inflation erodes the real value of all social transfers. This concerns most directly transfers that are defined as absolute amounts, like nursing care benefits or family and childcare benefits. Indirectly, also those transfers lose real value through inflation which, as income maintenance, are defined as a percentage of previous earnings (e.g., unemployment insurance or retirement benefits) and paid over an extended period. Regular valorisation of transfers may prevent their real value from being eroded by inflation. In addition, there are specific transfers designed to offset price jumps in certain sectoral markets, like subsidies to heating costs. They may be adjusted automatically or by discretion to the pace of inflation. Beyond extending or adjusting existing social and other specific transfers, policy may envisage the introduction of new unspecific transfers in order to offset an inflation-related loss of purchasing power.

Furthermore there are a number of *specific items of public consumption* that may serve as substitutes for market goods and services particularly affected by price increases. Examples are housing subsidies that may be geared towards energy-saving investment in order to lower heating costs for private households, or subsidies for public transport encourageing car drivers to switch and thereby save fuel cost.

Fiscal Drag

The term fiscal drag stands for the effect that taxpayers move into income brackets subject to higher marginal tax rates only because of their market income being adjusted to inflation, i.e., with real income remaining constant. Fiscal drag thus implies a rising average tax rate over time for constant real income; it is a major problem inherent to progressive tax schedules and the more so the steeper the profile of rising marginal tax rates. The inflation-induced erosion of tax allowances, tax credits and thresholds defined as absolute amounts also adds to fiscal drag. The latter can therefore affect also income tax systems with a proportional schedule if they apply such tax exemptions. Fiscal drag can be neutralised via indexation of tax thresholds or tax credits.

The Austrian tax schedule is characterised by four income brackets with constant marginal tax rate each: 0 percent up to a taxable annual income of € 10,000; 38¹/₃ percent for incomes from € 10,001 to € 25,000; 43.6 percent from € 25,001 to € 51,000; and 50 percent for income parts above € 51,000. Fiscal drag derives from the inflation-related move above the threshold to the next-higher tax bracket, from the depreciation of tax credits reducing the amount of tax due or of tax allowances lowering taxable income.

Problems

Budgetary measures to compensate a bout of inflation are fraught with a number of difficulties. As already mentioned, fiscal policy can only address the symptoms, but not the causes of inflation. Fiscal policy comes into operation only when inflation has already become manifest, and the measures at its disposal involve (potentially important) budgetary costs. Where instruments are triggered quasi-automatically without ad-hoc decision (such as the indexation of social transfers), budgetary resources are eo ipso committed and are therefore no longer available for structural reform on the spending or the revenue side, e.g., by reducing the scope for tax cuts. It is therefore much more efficient to tackle the root causes of inflation, where counter-action – like the enforcement of effective competition – requires considerably lower budgetary resources.

Furthermore, there is the danger that the cushioning of inflation consequences takes pressure off economic policy to squarely address the causes of inflation, notably since the latter will meet the resistance of those affected. This is particularly relevant for automatic adjustments which enter into force without prior political debate.

What follows from the above is an order of priorities for economic policy measures in fighting inflation. Top priority should be given to measures preventing or eradicating inflation that tackle the root causes which, if effective, render fiscal policy efforts to mitigate the impact of inflation redundant.

The current Austrian debate

The following critical assessment of measures implemented or discussed in Austria to neutralise the impact of inflation on private households is based upon the criteria of effectiveness, meeting social targets, compatibility with other economic policy goals and European policy constraints. On this basis, a number of policy recommendations for Austria will be formulated.

Measures envisaged or already implemented

In the context of the current economic policy debate in Austria on how to mitigate the repercussions of inflation a number of proposals have been advanced from different sides in the last few months which are meant (inter alia) to offset the impact of inflation. Some of these proposals have already been implemented (Table 1).

This catalogue of measures includes, first, cuts in taxes and contributions which lead to partly specific and partly unspecific relief. Specific exonerating effects may be expected from the increase in the kilometric allowance as well as from the standard commuter benefit and the commuter supplementary benefit, the cut of the VAT rate for food or fuel or the cut of the mineral oil tax. Unspecific exoneration effects derive from the abolition of the inheritance and gift tax[2], the cut in unemployment

[2] Following two rulings by the Constitutional Court in 2007, the inheritance and gift tax was to be phased out by the end of July 2008. Since no efforts were made to reform the tax, it was abolished as from 1 August 2008. The implicit lowering of the tax burden is interpreted by the political authorities as part of the current anti-inflationary measures.

insurance contributions for low incomes as well as an ad-hoc tax credit to compensate for inflation. Some of these measures have been the subject of debate also at the European level, notably those touching upon European legal prerogatives, such as the lowering of the reduced VAT rate for food or a cut of the mineral oil tax.

Table 1: Measures to compensate for inflation in Austria

End of August 2008

	Date of implementation	Budget amount million € per year	Decided	Effectiveness[1]	Meeting social targets[1]	Other
Taxes and contributions						
Specific relief						
Increase in km allowance to € 0,42	1 July 2008	25	Yes	+++	+	Ecologically counter-productive
Increase in commuter allowance				+++	+	
By 10 percent	1 July 2007	18	Yes			
By 15 percent	1 July 2008	35	Yes			
Introduction of commuter supplement (total € 130) to negative tax for low incomes (of which € 40 limited to 2008-09)	1 July 2008	20	Yes	+++	+++	Ecologically counter-productive
Cut of reduced VAT rate for food	.	150 per percentage point	No	++	++[2]	Limited scope by EU legislation
Cut of VAT rate for fuel	.	.	No	++	++	Little scope by EU legislation
Cut of mineral oil tax	.	.	No	++	++	Little scope by EU legislation
Unspecific relief						
Abolition of inheritance and gift tax	1 August 2008	140	Yes	+	+	
Cut or abolition of unemployment insurance contribution for gross earnings below € 1,350 per month	1 July 2008	300	Yes	+	+++	Positive employment effect
Inflation tax credit inclusive negative tax element for taxable income up to € 25,000 per year	.	800[3]	No	+	++	
Public charges						
Exemption for childbirth	1 January 2008	10	Yes	+	++	
Freeze for federal charges	1 July 2008	10	Yes	+	++	
Transfers						
Pension increase carried forward	1 November 2008	144	Yes	+	++	
Increase in nursing care benefit by 4 percent to 6 percent[4]	1 January 2009	120	Yes	+	++	
Subsidy increase for round-the-clock personal care and abolition of wealth ceiling	1 November 2008	40	Yes	+	++	
Increased family benefit (13th instalment)	.			+	++	
For children above 6 years		186	No			
For all children		238	No			
Public provision of substitutes						
Subsidy to Austria Ticket	Early 2009	107	No	+++	++	Positive environmental effect

Source: Federal Ministry of Finance, WIFO. – [1] + . . . low, ++ . . . medium, +++ . . . high. – [2] If tax cut is fully passed on by food retailers. – [3] Total includes further relief measures of small amount, e.g., heating cost subsidies. – [4] For details, see http://www.bmsk.gv.at/cms/site/news_einzel.htm?channel=CH0008&doc=CMS1218535982530.

With the exception of the suggested lowering of the reduced VAT rate for food, all proposed or already implemented specific relief measures focus on fuel prices which next to the agricultural markets account for a large part of overall inflation. What is suggested for discussion is the prolongation of tax deductions for inflation-related additional expenditure (kilometric allowance, standard and supplementary commuter allowance) in the income tax or tax cuts for fuel (mineral oil tax or VAT).

Second, on the revenue side, *public charges* have been *lowered*, namely the exemption from all charges related to childbirth and a freeze of charges to be paid to the federal government, i.e., the cancellation for 2008 of the valorisation of all federal public charges as agreed in the previous government programme.

A third set of measures relates to public expenditure. Some of them have already been decided, such as for *public transfers* the carrying-forward of the annual adjustment of retirement benefits from January 2009 to November 2008 and the increase in nursing care benefits by 4 percent to 6 percent as well as higher subsidies for round-the-clock personal care. Still being discussed is the increase in family benefits through a 13th annual instalment.

The (likewise not yet decided) subsidisation of the "Austria Ticket" for the individual use of all means of public transport for an annual lump sum of € 1.490[3] as from 2009 can be considered as *public offer of a substitute* for the use of a private car which has been severely affected by inflation.

Specific tax relief

Both the effectiveness and the accuracy of meeting social targets of the specific relief measures need to be judged differently by case.

The effectiveness of the tax measures to reduce the cost for commuters is high. It is less so for the proposed cuts in indirect taxes. Admittedly, the latter are concentrated on markets particularly hit by inflation. However, it is plausible to assume that the tax cuts will not be passed on in full to the consumers by the suppliers operating in these oligopolistic markets.

The degree of social accuracy is highest for the commuter supplement to the negative income tax. It benefits all those tax subjects whose income is below the tax threshold and who are entitled to negative tax. However, there is the problem of non-submission of claims inherent to all tax concessions granted only on demand: due to lack of information or to the implied bureaucratic burden such tax benefits often do not reach the people in low-income groups.

The tax deductability of the kilometric allowance and the commuter benefit implies, however, a degressive impact, i.e., the amount of exoneration rises with income. Moreover, about 40 percent of the tax subjects do not benefit from it as they are below the income tax threshold. The social accuracy is therefore rather low.

The social accuracy is limited also for cuts in indirect taxes. Although they provide greater relief for low-income than for higher-income earners, they benefit consumers across the board, giving rise to deadweight losses among the higher-income groups. In particular, a sizeable cut in the VAT rate ought to be judged sceptically. The regressive effect of VAT is already now mitigated by the existing reduced rates for certain goods and services. In a recent study, the OECD emphasises the superiority with regard to social accuracy of direct payments vis-à-vis a lower VAT rate (*Johannson et al.,* 2008). Although the mineral oil tax has effectively a regressive schedule, the latter is less pronounced than for other indirect taxes since households with low income typically have relatively few cars.

The scope offered by European legislation for a cut in the VAT rate or in the mineral oil tax rate is not very wide. For VAT, a maximum of two reduced rates are allowed, with a minimum rate of 5 percent. Austria has introduced a reduced VAT rate of 12 percent for direct sales of wine by producers. A second reduced rate of 10 percent (half the standard rate of 20 percent) applies to a further number of goods deemed to belong to the socio-cultural level of subsistence, like books and other printed materials, rents or food. If the VAT rate for food were to be reduced, either the reduced 12 percent rate would have to be abolished or the lower rate for food would have to be extended to all other goods in this category. Both options would imply substantial revenue losses: the first one of about € 750 million per year, the second one of more than € 2 billion per year. The mineral oil tax rate in Austria exceeds only by little the legally defined minimum EU rate, thus offering only little scope for a reduction.

Furthermore, both the enhanced income tax deductability of individual transport cost via a higher commuter allowance etc. and a cut in fuel taxes would be counter-productive from an environmental perspective. From the latter one may consider tying income tax concessions to certain conditions like the use of public transport for at least part of the way to work.

[3] For retirees € 1,190, for young people € 990.

Unspecific tax relief

The effectiveness of unspecific tax relief is by definition limited.

The social accuracy of an abolition or reduction of unemployment insurance contributions for monthly gross earnings up to € 1,350 is high. It is somewhat lower for the inflation tax credit that would be granted for taxable annual incomes up to € 25,000: beneficiaries would not be the lowest-income earners only and not all of the latter would benefit since the inflation tax credit would have to be claimed in the context of an employee's tax declaration. A related problem is the important time lag for the relief to actually take effect. Finally, the inflation tax credit would benefit only people liable to wage and income tax, but not transfer income recipients, except people receiving retirement benefits. The abolition of the inheritance and the gift tax is a benefit of low social accuracy given the unequal distribution of private wealth and the progressivity of the tax schedule.

From the viewpoint of European legislation, there are no constraints to any unspecific tax concession. As regards the compatibility with other economic policy goals, the positive employment effects of a cut in unemployment insurance contributions should be underlined.

Exoneration from public charges

The already implemented abolition of charges related to childbirth and the freeze in 2008 on charges collected by the federal government[4] have a low degree of effectiveness. For both measures, social accuracy is limited: on the one hand, all people liable to pay charges will benefit from the cuts, independent of their income level; on the other hand, the distributional impact of charges is regressive, such that low-income households will be exonerated above-average (in relative terms) by their cuts.

Exoneration through transfers

The effectiveness of the increase in transfers already implemented or still discussed is low.

The social accuracy of the frontloading of the adjustment of retirement benefits as well as of the additional monthly instalment of the family allowance is likely to be limited, since all recipients will benefit from these measures whether in need or not. The same is true for the increase in the nursing care benefit and the subsidy to the round-the-clock personal care, since for the latter the private wealth ceiling will be waived.

Public provision of substition goods

The envisaged subsidisation of the Austria Ticket is deemed highly effective since it is geared specifically towards the alleviation of the high fuel cost burden. Its social accuracy is likely to be limited. On the one hand, low-income households are particularly hit by the jump in fuel prices, provided they have a car at all. On the other hand, the subsidised ticket may be claimed independent of the individual income level. From the environmental perspective, the Austria Ticket is welcome since it encourages people to switch from individual towards public transport.

Recommendations for Austria

Even if one or the other of the inflation-offsetting measures discussed above includes some meaningful elements, the whole set of single measures already introduced or advanced for discussion must be judged sceptically from an overall perspective, for more than one reason.

Generally speaking, this is a bundle of un-coordinated measures that are not integrated into a coherent overall framework, neither as far as the compensation of redistributional effects of inflation is concerned, nor for the revenue measures with regard to the major tax reform planned for 2010. Some of the measures even bear no relation at all to the problem of inflation. The danger is therefore that the anti-inflation measures already implemented or the further ones planned will prove ineffective. In addition, these measures commit as from now substantial financial resources which will no longer be available for the comprehensive 2010 tax reform. The measures already decided will by themselves cost € 860 million per year[5], equivalent to almost one-third of the total € 2.7 billion foreseen for the 2010 tax reform.

[4] The government agreement provided for a regular valorisation of public charges which, however, was suspended for 2008.

[5] Information available by end-August 2008.

It is occasionally argued that the government benefits from high inflation via extra tax and contribution revenues which can or should be returned to private households through the financing of inflation-compensating measures. However, any inflation-related extra government revenues are only temporary, i.e., confined to periods of stronger price increases. By contrast, the anti-inflation measures implemented or decided provide permanent relief unless they are explicitly linked to a certain inflation threshold being exceeded (inflation tax credit) or are granted for a limited time (part of the commuter supplement to the negative tax). For budgetary reasons, but also on efficiency grounds the principal question arises whether a temporary phenomenon should be countered by permanent tax relief measures.

In addition, the hypothesis of the government being a gainer from inflation cannot be confirmed a priori. Taxes differ by category and by their impact over time. In a first round, price increases induce extra revenues through (possibly) rising tax bases[6]. Most directly this is the case for ad-valorem (i.e., defined as a percentage of the net sales price) consumption taxes; in Austria, VAT, the car registration tax and the insurance tax fall into this category, together accounting for around € 23.3 billion in the draft federal budget for 2008 (of which VAT € 21.7 billion) or almost 36 percent (VAT nearly 33 percent) of federal tax revenue. Also nominal corporate earnings and thus profit-related taxes are boosted by inflation; the latter include the assessed income tax and the corporate tax, together estimated to yield € 8.75 billion in revenues in 2008 or over 13 percent of total federal tax revenues.

Indirectly, price increases can impact on further tax bases if the latter are adjusted for inflation, in particular wages and salaries as well as interest income. In that case, revenues from all wage-related taxes and from capital gains tax would increase. The latter will yield € 1,55 billion or more than 2 percent of total federal tax revenues in 2008.

The wage-related taxes include at the federal level the wage tax and the contribution to subsidised residential building, together amounting to € 20.76 billion or nearly 32 percent of federal tax revenues. Of that amount, € 20 billion are accounted for by the wage tax; it has a progressive schedule, such that an inflation-driven increase in the tax base will give rise to fiscal drag and hence an over-proportional increase in tax revenues, leading also to a higher tax-to-GDP ratio. In addition, there are the revenues from social security contributions amounting to € 42.8 billion in 2007.

No inflation-induced extra revenues may be expected from volume-related (i.e., collected at a fixed absolute amount) excise taxes, including in Austria the energy tax, the mineral oil tax, the alcohol tax, the beer tax, the motor car tax and the car-engine-related insurance tax. Revenues from these taxes are estimated at € 6.37 billion or nearly 10 percent of total federal tax revenues for 2008[7]. Price increases can, on the contrary, give rise to revenue losses for these taxes if they lead to lower consumption as has been observed for fuel consumption over the last months.

In any case, higher inflation will lead to an erosion of the real yield from these taxes. This is also the case for public charges received by the federal government which are estimated at € 850 million or over 1 percent of total federal tax revenues in 2008.

The above-mentioned potential additional tax revenues should, however, be set against not only any inflation-induced revenue shortfalls, but also against higher spending, since also the government is affected by price increases, depending on the composition of its expenditure: this goes in particular for public wages and salaries, purchases of goods and indexed or periodically adjusted transfer payments. The relation between extra revenue and extra spending defines the budgetary leeway for inflation-offsetting relief measures. Whether the current wave of inflation ac-

[6] The following considerations limit themselves to federal taxes and social security contributions, because the current discussion in Austria focuses on measures affecting the budgets of the federal government and the social security agencies. Inflation-sensitive taxes of other territorial authorities, in particular the communal tax, as well as revenues of public funds from taxes linked to wages (family benefit fund and the fund compensating wage losses in the case of insolvency) are neglected here.

[7] Extra revenues from price increases for these goods and services will only accrue to VAT to the extent that these goods and services are subject to VAT.

tually creates such greater leeway would need to be investigated more closely beyond the present analysis.

Finally, non-targeted and uncoordinated compensation measures not subject to a time limit carry the danger that by addressing the symptoms pressure for reform is taken off in the very areas where the real causes of inflation lie, such as in competition policy.

In view of these considerations it appears more meaningful within the limited budgetary room for manoeuvre to focus on measures which specifically compensate the consequences of inflation only in times when the latter shifts markedly upwards. Priority should be given to the regular compensation for fiscal drag and the regular adjustment of social transfers, amounting to an effective and targeted protection of private households against the consequences of inflation. These measures may be supplemented by specific transfers or public provision of substitutes focusing on sectoral markets most affected by price jumps, like subsidies to heating costs or expenditure on public transport in case of massive price increases for fuel and heating material.

A third group of measures should briefly be addressed here, even if they do not mitigate the consequences of inflation for private households, but which are worth considering for budgetary and fiscal incentives reasons: the regular valorisation of excise taxes.

Table 2: Size of fiscal drag in Austria by level of taxable income

Tax base according to schedule[1]		Tax according to schedule, inclusive employee and commuter tax credit		Average tax rate		Fiscal drag	
						Change 2005-2008	
2005	2008	2005	2008	2005	2008		
In €		In €		In percent		In €	Percentage points
933	1,000	– 25	– 26	– 2.65	– 2.62	– 1.5	+ 0.03
1,865	2,000	– 45	– 48	– 2.42	– 2.41	– 3.0	+ 0.02
2,798	3,000	– 66	– 70	– 2.35	– 2.34	– 4.4	+ 0.01
3,730	4,000	– 86	– 92	– 2.31	– 2.30	– 5.9	+ 0.01
4,663	5,000	– 107	– 110	– 2.29	– 2.20	– 3.4	+ 0.09
5,595	6,000	– 110	– 110	– 1.97	– 1.83	± 0.0	+ 0.13
6,528	7,000	– 110	– 110	– 1.69	– 1.57	± 0.0	+ 0.11
7,460	8,000	– 110	– 110	– 1.47	– 1.38	± 0.0	+ 0.10
8,393	9,000	– 110	– 110	– 1.31	– 1.22	± 0.0	+ 0.09
9,325	10,000	– 110	– 110	– 1.18	– 1.10	± 0.0	+ 0.08
10,258	11,000	– 110	38	– 1.07	0.35	+ 148.3	+ 1.42
11,191	12,000	111	422	1.00	3.51	+ 310.3	+ 2.52
12,123	13,000	469	805	3.87	6.19	+ 336.1	+ 2.32
13,056	14,000	826	1,188	6.33	8.49	+ 362.0	+ 2.16
13,988	15,000	1,184	1,572	8.46	10.48	+ 387.9	+ 2.01
14,921	16,000	1,541	1,955	10.33	12.22	+ 413.7	+ 1.89
15,853	17,000	1,899	2,338	11.98	13.75	+ 439.6	+ 1.78
16,786	18,000	2,256	2,722	13.44	15.12	+ 465.4	+ 1.68
17,718	19,000	2,614	3,105	14.75	16.34	+ 491.3	+ 1.59
18,651	20,000	2,971	3,488	15.93	17.44	+ 517.1	+ 1.51
23,314	25,000	4,759	5,405	20.41	21.62	+ 646.4	+ 1.21
25,179	27,000	5,483	6,277	21.78	23.25	+ 794.0	+ 1.47
27,976	30,000	6,703	7,585	23.96	25.28	+ 882.2	+ 1.32
32,639	35,000	8,735	9,765	26.76	27.90	+ 1,029.3	+ 1.14
37,302	40,000	10,768	11,944	28.87	29.86	+ 1,176.3	+ 0.99
41,965	45,000	12,801	14,124	30.50	31.39	+ 1,323.3	+ 0.88
46,627	50,000	14,834	16,304	31.81	32.61	+ 1,470.4	+ 0.79
51,290	55,000	16,885	18,740	32.92	34.07	+ 1,855.0	+ 1.15
55,953	60,000	19,216	21,240	34.34	35.40	+ 2,023.6	+ 1.06
65,278	70,000	23,879	26,240	36.58	37.49	+ 2,360.9	+ 0.91
74,604	80,000	28,542	31,240	38.26	39.05	+ 2,698.1	+ 0.79
83,929	90,000	33,205	36,240	39.56	40.27	+ 3,035.4	+ 0.70
93,255	100,000	37,867	41,240	40.61	41.24	+ 3,372.7	+ 0.63

Source: WIFO calculations. – [1] 2005 comparable in real terms.

Compensation of fiscal drag

The impact of fiscal drag is revealed by a comparison of average tax rates of nominal income with those of the corresponding real income that is deflated by the consumer price index for a certain base year. As base year we use here 2005, i.e., the year when the second leg of the last major tax reform 2004-05 was implemented

(Table 2). As can be seen, all income brackets are affected by fiscal drag, but particularly severely the lower-income brackets (with a taxable annual income of up to € 12,000), where progressivity of the tax schedule is markedly strong. Thus, the compensation of fiscal drag has also a social dimension.

Table 3: Tax credits in Austria

2008

	Introduction	Level at introduction	Current level	Increase since introduction	Inflation (CPI) since introduction	Last valorised
		In €	In €	In percent	In percent	
Child tax credit	1993	51	51	±0,0	+33,9	1993
Multiple-children supplement (for third and each further child)	1999	15	36	+150,5	+21,5	2002
Employee tax credit	1973	80	54	–32,4	+223,5	
Commuter tax credit	1989	291	291	±0,0	+54,1	1989
Single-earner tax credit[1]	1973	109	364	+233,9	+223,5	1993

Source: WIFO, Federal Ministry of Finance. – [1] Basic amount, since 2004 increased by child supplements.

The tax credits granted within the framework of the income tax code are not regularly adjusted for inflation. The child tax credit and the transport tax credit have meanwhile been significantly reduced in their real value (Table 3). The inflation-induced erosion of the multiple-children supplement to the child tax credit and the single-earner tax credit have each been offset to a higher degree by discretionary adjustments.

Table 4: Automatic and discretionary adjustments to prevent fiscal drag in OECD countries

	Income tax	Family benefits	Social security contributions
Australia	No	Yes	.
Austria	No	No	Yes
Belgium	Yes	Yes	No
Canada	Yes	Yes	Partially
Czech Republic	.	Yes	.
Denmark	Yes	Yes	Yes
Finland	Yes	.	.
France	Yes	.	Yes
Germany	No	No	Partially
Greece	No	.	Yes
Hungary	Yes	Yes	Yes
Iceland	Yes	Yes	Yes
Ireland	No	Yes	Yes
Italy	No	No	Yes
Japan	No	No	.
Korea	No	No	.
Luxembourg	No	Yes	Yes
Mexico	Partially	.	Yes
The Netherlands	Yes	Yes	Yes
New Zealand	No	No	.
Norway	Yes	No	Yes
Poland	No	Yes	Yes
Portugal	Yes	Yes	.
Slovakia	Yes	Yes	Yes
Spain	Yes	.	Yes
Sweden	Yes	No	Yes
Switzerland	Yes	Yes	.
Turkey	Yes	.	Yes
UK	Yes	Yes	Yes
USA	Yes	Yes	Yes

Source: *OECD* (2008).

The "disguised" increase in the income tax burden via fiscal drag can be avoided either by automatic indexation or an annual adjustment of tax brackets as well as of tax allowances and tax credits by law (*Projektgruppe Gemeinschaftsdiagnose,* 2007). Many OECD countries have made provisions to neutralise the effect of inflation in the income tax (Table 4). Either automatic or discretionary adjustments are made, but not necessarily in a comprehensive way (including all income tax regulations). Most countries take measures against the effect of fiscal drag on social security contributions (Table 4).

Regular valorisation of public transfers

Among the public transfers in Austria defined as absolute amounts only social assistance and the minimum pension are adjusted annually by the rate of headline inflation of the preceding year (Table 5). The annual increase in social retirement benefits is also supposed, i.a., to protect the real value of pensions.

The other transfers listed in Table 5 (family allowance, child care benefit and nursing care benefit) are not subject to regular valorisation. The child care benefit of € 436 per month[8] has remained constant since its introduction in 2002, the nursing care benefits introduced in 1993 has been raised three times (in 1994 by 2.5 percent, 1995 by 2.8 percent and 2005 by 2 percent). Thus, the lately decided increase in the nursing care benefit only partly offsets the cumulated effect of inflation observed since the implementation of this benefit. No periodic adjustments are foreseen either for unemployment benefits.

Table 5: Major transfer payments in Austria

2008

	Introduction	Level at introduction	Current level	Increase since introduction	Inflation (CPI) since introduction	Last valorised	Total amount 2007
		In €		In percent			Million €
Family allowance[1]	1955	11	105	+ 867.0	514.5	2000	3,007
Child care benefit[2]	2002	436	436	± 0.0	13.6	2002	999
Nursing care benefit	1993				33.9	2005	1,541 + 304 [3]
Step 1		182	148	– 18.5			
Step 2		254	273	+ 7.3			
Step 3		392	422	+ 7.5			
Step 4		589	633	+ 7.5			
Step 5		799	859	+ 7.5			
Step 6		1,090	1,172	+ 7.5			
Step 7		1,453	1,562	+ 7.5			
social assistance (Vienna, single person, normal rate)	1961	33	439	+ 1,242.5	432.3	Annually	454 [4]
pensions, minimum threshold	1955	33	747	+ 2,134.5	514.5	Annually	932

Source: WIFO. – [1] Basic amount for 1st child; increases at age 3, 10 and 19 of a child and with the number of children. – [2] Regulation until 2007, for duration up to 36 months; as from 2008, different levels by duration. – [3] Sum of benefits granted by federal government and *Land*. – [4] General social assistance benefit.

If the gradual erosion by inflation of the value of public transfer payments is to be avoided, the latter would also have to be adjusted each year by the rising costs of living. Indeed, a number of OECD countries prevent such erosion of family benefits by an automatic or discretionary adjustment mechanism (Table 4).

The synopsis of expenditure on the social transfers considered here conveys an idea on the likely cost of their indexation. In 2007, these transfers amounted to a total € 7,237 billion. At the current rate of inflation around 4 percent, indexation would have led to additional expenditure of € 290 million.

Regular valorisation of excise taxes

A third area where a regular cost-of-living adjustment may be envisaged is that of volume-related specific consumption taxes (excises). Since they are defined as absolute amounts, they too are reduced in their real value by inflation. From the perspective of fiscal policy, a regular automatic inflation adjustment for these taxes protects the real value of their yield. In addition, there is an allocation aspect involved for those excise taxes which are to provide incentives for consumption, notably due to environmental concerns, like energy taxes or the motor car tax: their valorisation prevents such incentives to fade with inflation progressing. As mentioned earlier,

[8] The amount of € 436 per month is granted up to a maximum duration of 36 months; as of 2008, there are two options for the level and duration of the child care benefit: € 624 for up to 24 months, or € 798 for a maximum of 18 months.

their total revenue is estimated at € 6.37 billion for 2008. An adjustment by the current rate of inflation of about 4 percent would mechanically yield an additional € 250 million which may contribute to the financing of the inflation-compensating measures.

Concluding remark

For the fight against inflation, fiscal policy should assume only a subordinate role since it can only cushion the impact of a bout of price increase without addressing the causes. In view of the potentially substantial cost of fiscal anti-inflation measures and the implicit danger that they may take pressure off the efforts to eliminate the root causes, policy action should concentrate on prevention and elimination of waves of inflation.

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Fiscal Policy Tools of Compensating for Inflation – Summary

Given the above-average price increases experienced in Austria since the end of 2007, anti-inflationary measures are at the centre of the ongoing economic-policy debate, with a strong focus on budget policy. The current price surge also needs to be looked at from the viewpoint of distribution policy: on the one hand, transfer payments by the government to private households are subject to depreciation in real terms; on the other hand, the inflation-related real loss of purchasing power of both earned income and transfer payments particularly affects low-income earners, who spend much or all of their disposable income on consumption. All budget policy can do is (partially) neutralise the effect of price increases on the income distribution; it is not able to contribute towards eliminating the causes of inflation.

The criteria applied to evaluate the individual budgetary policy measures intended to offset the consequences of inflation include their ability to meet social targets, their effectiveness, and their compatibility with other economic policy objectives and the requirements of European law. Variations of taxes, social security contributions and public charges are possible revenue-side approaches, while state transfer payments and the provision of public services as substitutes for goods particularly affected by inflation can be considered on the expenditure side.

Considering that fiscal policy can only fight the symptoms but not the causes of inflation, its instruments are employed at a time when prices are already going up. Public funds (often in substantial amounts) are required to finance the measures to be taken. It is therefore much more efficient to focus on the causes of inflation. Moreover, cushioning the impact of inflation is likely to ease the pressure on economic policy to combat the causes of inflation through vigorous action, all the more so if such action will encounter considerable resistance from those concerned. This holds, in particular, for automatic adjustments (e.g., indexation of social transfers), as these take effect without public policy debate. On this basis, a hierarchy of anti-inflationary policy measures can be established. Top priority must be given to measures intended to prevent and/or eliminate inflation by aiming at the root causes of a price surge. Effectively eliminating the causes of inflation obviates the need for budget policy measures to compensate for its impact.

The steps currently debated and/or already taken in Austria present themselves as a bundle of uncoordinated measures in the absence of an overall concept: they are neither part of a co-ordinated effort to offset the effects of inflation on the income distribution, nor do they fit into an overall regime – as far as revenue-side measures are concerned – for the large-scale tax reform planned for 2010. Thus, the effectiveness of the measures taken or planned to combat inflation is at risk. Moreover, these measures absorb substantial funds which will be lacking in the context of the "overall" tax reform envisaged for 2010. Finally, the majority of the measures proposed and implemented will result in permanent relief, even though – for both budgetary and efficiency reasons – the fundamental question arises whether a temporary phenomenon is to be countered with permanent relief measures.

In view of the above and given the limited scope of budget policy, the purpose of combating inflation would be better served by measures specifically designed to offset the impact of accelerated inflation in the event such a development occurs. Offsetting the effect of fiscal drag and increasing the level of social benefits on a regular basis to compensate private households for the consequences of inflation are matters of priority in this context. Other measures to be recommended include specific transfer payments and/or government funding for the public provision of substitution goods in sectoral markets particularly affected by price increases, e.g., heating cost allowances and government expenditure for public transport in times of drastic fuel price increases. Another set of measures advisable for reasons of budget and regulatory policy comprises regular adjustment of specific excise taxes.

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