# MAIN RESULTS OF THE AUSTRIAN REPORT ON PUBLIC FINANCES 2006 [1]

*ECONOMIC FRAMEWORK, THE FISCAL POSITION OF THE PUBLIC SECTOR AND THE FEDERAL GOVERNMENT'S DEBT ACTIVITIES IN AUSTRIA IN 2006*

## Economic Framework and the Fiscal Position of the Public Sector in Austria in 2006

- In 2006 compared with the previous year, the **Austrian economy** had a robust growth rate of 3.1%, which was almost as high as in the economic boom year 2000. Austria's real GDP was unmistakably above that of the euro area (EU-13), which according to Eurostat was +2.6% compared with the previous year. This growth was mainly supported by an expansion of gross investments and higher net exports.

- In 2006 the European Central Bank Council raised the **key interest rate** for the **euro area** to 3.5% (minimum bid rate) in five steps. **Money market interest rates** increased closely parallel to key rate increases (3-month Euribor: 2006: 3.1%; 2005: 2.2%). **Long-term bond yields** in the **euro area** increased markedly in the first half of 2006. In the third quarter a lowering of U.S. interest rates caused bond yields to fall. Annual average long-term bond yields rose by 42 basis points to 3.8%. **The yield curve** became considerably flatter in the course of 2006.

- In 2006 the **budget deficit of the general government** turned out to be much less than had been expected: The Federal Ministry of Finance was assuming (September 2006) a budget deficit of 1.7% of GDP, while the results of Statistics Austria of March 2007 showed a negative budget balance of only 1.1 of GDP for 2006. Compared to the previous year, the budget deficit of the general government decreased by 0.5 percentage points in 2006.

- On an **international basis** the fiscal position of Austria continues to be relatively favorable. With a budget deficit of 1.1% of GDP in 2006, the year under review, Austria remained considerably below the 3-percent limit of the Maastricht Treaty. In addition the budget deficit of Austria was below the average deficit rates of the EU states (EU-13: -1.6%. of GDP, EU-27: -1.7 % of GDP). However, an increasing number of EU states are

[1] Source: Staatsschuldenausschuss, Bericht über die öffentlichen Finanzen 2006, Vienna 2007 (English version of chapter 7).

recording budget surpluses. In 2006 high budget surpluses were recorded by Denmark (+4.2% of GDP), Finland (+3.9% of GDP), Estonia (+3.8% of GDP), Bulgaria (+3.3% of GDP), Ireland (+2.9% of GDP), Sweden (+2.2% of GDP) as well as Spain (+1.8% of GDP).

- At an overall rate of 4.0% the **revenue of the public sector** rose much more sharply in the year under review than in the previous years (on average 2002 to 2006: 2.7% per year). The high economic growth rate and the positive profit results of domestic enterprises more than compensated for the loss of revenue from the tax reform 2004/2005. In 2006 the **amount of federal tax revenues shared with provinces and municipalities** was more than 2 billion euros above the amount predicted by the federal government. Of this amount about 1.5 billion euros remained with the federal government. Nevertheless a decrease in the **public revenue ratio** of 0.3 percentage points to 47.9% of GDP was recorded in light of a nominal GDP growth of 4.7%. In 2006 the **tax ratio of the general government amounted** to 42.0% of GDP and developed parallel to the tax revenue ratio of the general government. The decrease of the fiscal burden was noticeably less distinct than in the previous years (2006: -0.2 percentage points; 2005: -0.7 percentage points).

- In 2006 **expenditures of the general government** rose by a total of 3.1%. Thus they only moderately exceeded the average of the past five years of 3.0% per annum. On the expenditure side, the reform measures taken in the previous years (pension reforms, administration reforms, stricter budget controlling), a lowering of unemployment, the discontinuation of reflationary measures (special investment tax credit) as well as restrictions on discretionary expenditures helped to curb the dynamism of expenditures. On the other hand, public budgets were additionally burdened by the Package of Measures of 2005 to increase employment and research ("Apprentice Initiative", "Regional Employment and Growth Initiative 2005/2006", "Law for Enhanced Employment Prospects 2006", "Offensive to Revive Research Activities") as well as by dynamic expense positions (above all in health care). In 2006 the **expenditure ratio** of the general government showed a strong reduction (2006: 49.1% of GDP, 2005: 49.9% of GDP).

- The **sectoral distribution of the public budget balances** according to Maastricht show that according to preliminary results the **federal level** markedly improved its budget balance in 2006 (2006: -1.5% of GDP; 2005 -1.8% of GDP), while the budget surpluses at **the provincial and local levels** barely increased (2006: +0.4% of GDP; 2005: +0.3% of

GDP). These diverging developments reflect, among other things, the situation that factors influenced by economic cycles affect mainly the federal level. Additionally, the provinces and municipalities – in particular as a result of the persistent expenditure dynamism in the health sector, but also through higher financing costs of debt and increased subsidies – have hardly utilized their additional revenues or lower expenditures resulting from the economic cycle to increase their surpluses. **Social security funds** are expected to have nearly balanced budgets for 2006.

- However, the **stability contribution of the provinces (including Vienna)** in the amount of 0.6% of GDP on the basis of the **Austrian Stability Pact 2005** is expected to have been reached in 2006. The main reason was the accelerated use of measures that – deviating from the ESA 95 definitions - were permitted to be applied for the last time. Included are, in particular, proceeds from the transfer of properties to real-estate enterprises of the provinces and loans made to public hospitals, which are neutral for the measurement of deficit. Also the **stability contribution** on the **local level (not including Vienna)** – an (annual) balanced budget on the basis of the Austrian Stability Pact 2005 – is likely to be achieved again in 2006, the year under review.

- **Structural shifts** in **public expenditures** show the following: In the period from 2002 to 2006 **transfers to market producers** and **social benefits in kind to private households** at current expenditure rates of 12% and 11% reached their highest increases on average of 6.2% and 4.7% per annum respectively. These dynamics seem to be mainly the result of cost increases in health care. Programs to increase growth and employment of the federal government (special investment tax credit, research subsidy, educational bonus, apprenticeship subsidy etc.) are additionally reflected in the **transfer payments to market producers**. In contrast, from 2002 to 2006 **monetary transfer payments to private households**, which bind more than 37% of the total volume of public expenditures, showed a comparatively low increase of 3.0% per annum, which corresponds to that of the **annual total expenditure growth of the general government**. At a rate of 19% of total expenditures, **compensation of public employees** also showed an increase of 3.0% per annum; with a recent rate of 6%, **interest payments** for the public debt showed a slight decrease of 0.1% per annum on average.

- At a most recent rate of 2.1% of total expenditures, the **gross investments** of the state decreased between 2002 and 2006 by 0.9% per annum. Institutional changes in the public sector in 2001 (spinning-off of hospitals and market-like services at the central and municipal level) not only caused a definite decrease in public investments in 2001 in the sense of ESA 95 but also lead to the fact that investment financed by public funds in the ESA 95 category of gross investments are hardly discernable. If the **investments of the spun-off units**, which in the past had been part of the public sector, are included the **investments of the state**, the **gross investments of the state** (including spun-off units, not including Austrian Federal Railways) show a figure of 5 billion euros, with a tendency to increase in nominal figures (2006: 5.5 billion euros or 2.1% of GDP; 2002: 5.2 billion euros or 2.4 of GDP). Leasing finance (operating leasing) is not included in these figures.

- On the **revenue side**, in the period from 2002 to 2006 the weak business cycle at the beginning of the period under review and the Tax Reform 2004/2005 curbed the volume of tax revenue. The increase in **overall tax revenue** amounted to 2.4% per annum on average. Although losses in revenue from the Tax Reform 2004/2005 were lower than expected, at 2.3% per annum, the average increase in **direct taxes** from 2002 to 2006 was less than the overall tax development. At 2.6% per year, revenues of the state from **indirect taxes** expanded more sharply within the period under review. **Social insurance contributions** are included in taxes in a broader sense and have a share of overall revenues of about 33%. Between 2002 and 2006 **actual social contributions** developed dynamically in spite of the tight situation on the labor market (on average 2002 to 2006: +3.6%) due to improving employment figures and increases in contributions.

- There are very close financial connections between the four sub-sectors of the state: although the tax ratios regulated in the Financial Equalization Act (FAG) are directly entered as tax revenues of the respective public administrative body, the **intergovernmental transfer revenues** of the **provinces** and of the municipalities cover more than half and around one-fifth of the total income, respectively. With **social security funds,** in particular the federal contribution to pensions results in an intergovernmental revenue ratio of more than 25%. On expenditure side, it becomes evident that essentially the **federal level** (co-) finances services that are offered by other public bodies. In 2006 intergovernmental transfer payments amounted to around 36 billion euros (that is 22% of total expenditures), about 25 billion euros of which were accounted for by payments of the federal government.

- From 2001 to 2006 **intergovernmental transfers** (on the expenditures side) expanded extremely dynamically (+5.7% per annum). This reflects the increasingly complex financing network of the public budgets in Austria and in this connection the need for a reform to disentangle competences and financing between the various levels of government. The dynamism of these transfer flows is further increased by the fact that areas of responsibility are being spun-off from the individual budgets and performed by sub-units on their own (funds, associations, other units). When only payment flows between the sub-sectors are observed (intergovernmental payment transfers not including those within the respective sub-sector), these transfers then increased by 3.8% per annum on average from 2002 to 2006.

- At the end of 2006, the **national debt in accordance with Maastricht** amounted to 159.5 billion euros and increased on the previous year by 3.9 billion euros (2005: 155.4 billion euros). Measured against GDP, the debt ratio was reduced by 1.3 percentage points from 63.5% (end of 2005) to 62.1% of GDP (end of 2006).

- At the end of 2006, the **federal level** accounted for 91.1 of the total national debt, the **provincial level** accounted for 4.7%, the **municipal level** (including Vienna) for 3.0%, and **social security funds** for 1.2%. In 2006 the national debt as percentage of GDP decreased by 1.5 percentage points to 56.6% of GDP, while the debt ratio of the provincial level and the social security funds increased by 0.2 percentage points and 0.1 percentage points respectively to 2.9% of GDP and 0.8% of GDP.

- The **creditor structure of the public debt** is dominated by the creditor structure of the federal debt. The federal government covered its financing requirement to a very great extent by means of issuing euro-bonds, which since the EMU was implemented have been acquired almost completely by foreign investors (in particular from the euro area). By the end of 2006, the share of **foreign debt** reached about 76%. The Austrian **banking sector** is the most important **domestic creditor** of public debt (end of 2006: 13%). At the end of 2006 **private investors** (enterprises and private households) held only about 1% (about 1.5 billion euros) of the total public debt. At the end of 2006 the indirect ownership of government securities through investment funds of private households amounted to over 2 billion euros.

# The Federal Government's Debt Activities and the Creditors' Structure in 2006

- The **debt of the federal government** (without own security holdings) reached 145.3 billion euros at the end of 2006 and thus was 3.9 billion euros or 2.8% above the comparable value of 141.3 billion euros of the previous year. Measured against GDP, the level of federal government debt decreased noticeably in the year under review (end of 2006: 56.6% of GDP; end of 2005: 57.7% of GDP).

- The **share of foreign currency debt** of the total debt (after swaps) decreased markedly once again on the previous year from 8.2% (end of 2005) to 5.7% (end of 2006). Although the federal government did not finance its needs exclusively in the form of euro borrowing, almost all-foreign currency borrowing was transferred into euro debt categories by means of derivative transactions (cross-currency swaps or forward foreign exchange contracts). **Revaluation gains** also lowered the foreign currency debts in 2006 (unrealized net gains 2006: 0.6 billion euros).

- The debt management of the federal government took advantage of the nominal interest level on the euro capital markets, which increased, but is still low from a historical point of view, in order to give priority to conclude **long-term financing at fixed interest rates**. Once again, **euro federal bonds** with an average time to maturity of 11.5 years were the principle source of financing. Extremely long maturities of up to 40 years were obtained by bank loans (promissory note bonds in euros), which covered about 5% of the gross total volume of issues.

- The **yield difference** of Austrian bonds to German federal bonds, which in the 10-year maturity segment have "benchmark status", has been very low since 2003 and did not change in the year under review compared to 2005. On an annual average of 2006, the yield difference compared to Germany for 10-year bonds was 2 basis points. With the exception of Greece, Italy, and Portugal, most other EMU states also showed a similar yield difference compared to Germany (EU-12-average 2006 (not including Luxemburg): 8 basis points, 2005: 5 basis points).

- The **structure of the federal government's debt** in Austria moved further towards euro forms. 79.7% of the debt of the federal government was accounted for by **euro federal bonds** (2005: 77.0%) and 94.3% by **all types of euro debts** (2005: 91.8%). The percentage of **credit and loan contracts** in euros decreased to 10.7% (2005: 12.2%). The euro debt** (after swaps) increased by a total of 7.3 billion euros or 5.6% to 136.9 billion euros.

- The **volume of foreign currency debt** expressed in terms of euros was 8.3 billion euros at the end of 2006 and thus was 3.3 billion euros under the value of the previous year of 11.6 billion euros. In 2006, the year under review, after swaps had been taken into consideration, there was no **new financing in foreign currency**. A comparison of the respective framework conditions on capital markets (interest rate level, interest rate differentials between currencies, circle of investors, liquidity, product mix) spoke for the euro financial market and against taking on any additional exchange rate risk. The share of Swiss francs in foreign currency debt was 56.9% (2005: 61.8%) and that of the Japanese yen was 43.1% (2005: 38.2%).

- In the year under review, the **foreign debt ratio of the federal government** showed an increase once again, which was due to the fact that **euro** debt securities of the federal government were acquired by foreigners. If the 10% share of securities owned by the federal government is not taken into account, foreign primary dealers through sale by tender or by syndicated issues acquired almost 98% of the volume of federal bond issues (2005. 97%).

- The average **remaining time to maturity** of the **total debt portfolio** rose once again in 2006, though less markedly than in the previous year. At the end of the year 2006 the average remaining maturity was 8.1 years and thus was 0.5 years above the value of the previous year.

- In 2006 the average **nominal interest rate** of the federal government's financial debt was reduced once again in spite of an increase in the time to maturity of 0.5 years and an increase in the market interest level from 4.6% (end of 2005) to 4.4% (end of 2006). This development was the result of substantial repayment of debt categories with a much higher nominal interest rate of up to 7.7%. In 2006, the market interest rate level had only a very small effect on the average nominal interest rate, in particular due to the high fix interest proportion of the debt, but also as a result of the increase in bonds. At the end of the year under review, 96.9% of the outstanding obligations of the federal government were fixed interest rate obligations (2005: 96.0%).

- In 2006, the year under review, the expenditure component "**interest costs"** for the debt increased much less compared to 2005 (2006: +0.13 billion euros; 2005; +0.43 billion euros). Through the federal government's remission of claims on intermediary financing of the public entities of the SCHIG (Railroad Infrastructure Company) and the OEBB (Austrian Federal Railways) at the end of 2004 in the amount of 6.1 billion euros, growth in federal government interest payment servicing showed an additional increase of around 275 billion euros. If **miscellaneous expenditures** are included, the **cost for the debt** totaled 6.85 billion euros (2005: 6.47 billion euros). In 2006 the expenditures of the budget component "miscellaneous expenditures" was once again below that of "miscellaneous revenues". At 75 million euros, the revenue surplus of 2006 was clearly lower than in 2005 (over 300 million euros).

- If the development of the interest costs for the federal government's debt is compared with national key figures, the following can be seen: there was an increase in the **interest-to-tax ratio** (measured against the net tax revenue of the federal government) as a result of the Tax Reform 2004/2005, which is in contrast to the previous year. This ratio is, however, expected to be reduced again by 2008. Interest payments (including miscellaneous expenditures) absorbed 16.9% of the federal government's taxation revenue in 2006, the year under review (budget section 52 "public taxes"; net tax achievements). The **interest-to-GDP ratio** was 2.7% of GDP in 2006 and thus slightly above the value of the previous year of 2.6% of GDP. The positive cyclical situation combined with decreasing interest expenditures is expected to lower the interest-to-GDP ratio of the federal government debt by 2008 to 2.4% of GDP, according to budget estimates.

## Conclusions

- In an international context the **fiscal position of Austria** continues to be relatively positive with a budget deficit of 1.1 of GDP in 2006 and a debt ratio of 62.2% of GDP. Both key figures were below the average deficit and debt ratios of the euro countries (deficit: -1.6% of GDP; public debt: 69.2% of GDP). However, in comparison to the year before, in spite of strong economic growth, the budget deficit of Austria was not reduced as much as the average of the euro area (Austria: -0.5 percentage points; EU-13: -0.9 percentage points).

- Without programs to curb the dynamism of expenditures (in particular in the area of health services), a comprehensive state reform program that reinforces the responsibilities of the individual levels of government, and structural reform programs that increase efficiency as well as facilitate the agreed-upon reduction of personnel (Administration Reform Program II), the postulated goal of a **balanced budget of the general government from a cyclical perspective** will hardly be realized **on a sustainable basis**.

- In connection with the **"quality" of public finances**, it can be seen that in the years 2002 to 2006 in the area of public expenditures there were mainly structural shifts toward transfers to private households in the form of transfers in kind and transfers to market producers (subsidies, capital transfers). Here principally the increasing costs of health care (in hospitals and in private practices), but also the measures of the federal government to promote growth and employment are reflected. If the investments of the spun-off entities, which in the past had been part of the state sector, are included in the investments of the state, the result is a moderate increase within the period under review of 1.3% per annum. Tax and contribution measures contributed to the fact that indirect taxes and social security contributions made up a larger share of the total amount of taxes and contributions. The tax-to-GDP ratio (tax and actual social security contributions in relation to GDP) decreased relatively sharply (2006: 42.0% of GDP; 2002: 43.8% of GDP). In comparison, the average tax-to-GDP ratio of the EU-13 countries was 40.8% of GDP in 2006.

- A **very low level of interest sensitivity in the public debt** is evident from the structure of the federal government's debt, which, as result of a shift in the debt-profile towards long-term financing with fixed interest rates in the year under review, 2006, continued to decrease. The positive refinancing effect at the federal level (replacement of debt categories with high interest rates by those with lower ones) is likely to become noticeably weaker by 2008, due to a lower volume of repayment and the development of market interest rates as expected from the present point of view. The planned reduction of the net deficit of the federal government combined with the extremely low interest sensitivity of the debt portfolio (long duration, high fixed interest components) is not expected to increase the interest expense of the debt if the market interest rates continue to rise.