7 MAIN RESULTS OF THE AUSTRIAN REPORT ON PUBLIC FINANCES 2007

7.1 Economic Framework and the Fiscal Position of the Public Sector in Austria in 2007

Results for the year under review 2007

- In 2007 the **Austrian economy** had a robust growth of 3.4% (2006: +3.3%) compared with the previous year and was clearly above that of the euro area (+2.6% on previous year). This economic growth was supported by an expansion of net exports.

- In March and June 2007 the **European Central Bank** raised its **key interest rate** in the euro area by 25 basis points in each of the two months to 4% (minimum bid rate). In the second half of the year there was increased volatility and a reassessment of risks on the financial markets as a result of corrections on the U.S. real estate markets. In 2007 on a yearly average basis at 4.28% the **3-month Euribor** was 120 basis points above the previous year's figure. In comparison yields of 10-year government bonds rose on an annual average by only 48 basis points to 4.31%. The **yield curve** developed inversely in the second half of 2007.

- **According to March 2008 results,** the **budget deficit of the general government** at 0.5% of GDP turned out to be much lower **in the year under review** than in 2006 (1.5% of GDP) and was considerably lower than expected. These are, however, **preliminary results**. In fact, preliminary results of the provinces for 2006 had to be revised downward from a budget surplus in the amount of 0.6 billion euros or 0.2 % of GDP (status: March) to a deficit of 0.3 billion euros or -0.1% of GDP (status: September 2007).

- On an **international basis** Austria has taken a midfield position with a budget deficit of 0.5 % of GDP in 2007. Given the very favorable economic environment 11 of the 27 EU members have already shown budget surpluses. The following countries recorded high budget surpluses as percentage of GDP: Finland (+5.3%), Denmark (+4.4%), Sweden (+3.5%), Bulgaria (+3.4%), Cyprus (+3.3%), Luxemburg (+2.9%), Estonia (+2.8%), Spain (+2.2% of GDP).

- In the year under review economic dynamics had a noticeable stimulatory effect on the **revenues of the public sector**. At 5.6% the increase was exceptionally high, exceeding the growth rates of the past 10 years. **Total revenues of the public sector** amounted to 129.6 billion euros in 2007. **The overall tax ratio** (tax revenues of the public sector and actually paid social security contributions including EU own resources) amounted to 41.9% of GDP and for the first time since 2001 showed a slight upward trend (2006: 41.8%). On an international comparison, Austria has a tax ratio of approximately 42% of GDP and is above the Euro-15 average of approximately 41% of GDP.

- In 2007 at 3.5%, **expenditure growth of the public sector** was relatively moderate (2003-2007: +3.4% per annum) on account of a special effect (purchase of military equipment incurring an expenditure of 0.5 billion euros or 0.2% of GDP). Public sector expenditures amounted to 131.4 billion euros in 2007. The **expenditure ratio** fell sharply (2007: 48.2 % GDP; 2006: 49.2% of GDP). Measures set by the federal government in 2007 (e.g. flexibilization of family allowance, fee exemptions for births, education and apprentice program, 24-hour attendance allowance, higher pension adjustments in 2008 and preliminary pension adjustment for 2009, abolishing federal fees in 2009, the Fiscal Equalization Act 2008-2013, demand-oriented guaranteed minimum income) will not have any significant budgetary effect until later. The effects will start in 2008, with a progressive impact on the budget in the following years.

- According to preliminary results of March 2008, **sectoral budget balances** of public bodies in Austria show that at the **federal level** the budget deficit was reduced in 2007 (2007: -0.6% of

GDP; 2006: -1.6% of GDP), while the budget surpluses of the provinces and municipalities increased only slightly in total (2007: 0.2% of GDP; 2006: 0.1% of GDP). **Social security funds** are expected to show a slight deficit of 0.1% of GDP (deficit of **state health insurance funds**).

- In spite of the positive development of revenues the **budget balances on the provincial level according to Maastricht** (excluding Vienna) had a very negative development in **2006** (2006: -0.1% of GDP; 2005: +0.1% of GDP). External factors, such as increasing demand in the fields of health and health care or higher costs of debt were not the only reasons for this negative development on the provincial level in 2006 (EUR -0.6 billion). In **2007** the provinces apparently did not make much headway in their consolidation efforts in spite of very high tax revenues. The improvement of the budget deficit by 0.1 percent (2007: -0.0% of GDP; 2006: -0.1% of GDP) was solely on account of the absence of a one-off effect in 2006 (guaranty for Bank Burgenland). However, the estimations of Statistik Austria for 2007 may be somewhat too cautious.

Midterm development of revenues and expenditures (2003 – 2007)

- Within the period 2003 to 2007 **social benefits in kind to private households** and **transfers to market producers (**subsidies, investment grants), with an expenditure share of over 11% in each case showed the highest increases averaging 5.5% and 4.1% per annum. Both of these developments reflect mainly rising costs in health care. In recent years higher amounts of transfers to market producers also went to the **transport** sector (mainly government-related corporations of all administrative bodies). This expenditure category also reflects the measures to promote growth and employment of the past legislative periods as well as the debt relief granted by the federal government to the ÖBB (Austrian Federal Railways) in 2004 (EUR 6.1 billion).

- **Monetary transfers** to private households, which tie up more than 37% of the total volume of public expenditures, showed a relatively low increase of 2.8% per annum from 2003 to 2007, which was considerably lower than the annual **total public expenditure growth** at 3.4% per annum.

- **Public administrative outlays** (compensation of employees, intermediate consumption), which most recently accounted for 28% of total public expenditures, showed an above-average rise in the period under review of 3.7% per annum.

- Direct public expenditures for **investments** have been losing significance for years (spin-offs, lease financing). If the **investments of the spun-off units** that were previously part of the government sector were included in **government investments**, the volume of public investments would be doubled. In that case gross investments reach a dimension of more than 5 billion euros, but are also showing a tendency to decrease (2007: EUR 5.39 billion or 2.0% of GDP; 2003: EUR 5.44 billion or 2.4% of GDP).

- On the **revenue side,** the weak economy and the Tax Reform 2004/2005 initially slowed down tax revenues in the period between 2003 and 2007. However, tax revenues later rose steeply as a result of the economic recovery. The increase in **total tax revenues** between 2003 and 2007 ranged from 1.2% (2005) to 7.3% (2007). At an average of 4.4% per annum the increase in **direct taxes** was significantly higher than that of **indirect taxes** at 3.5%. **Social security contributions** are included in taxes or charges in the broader sense and have a share of 33% to 34% of total revenues. The increase in **overall public revenues** was 3.8% per annum from 2003 to 2007 and thus exceeded the annual **overall expenditure growth** of 3.4% on average.

- There are very close **financial entanglements** between the **sub-sectors of the state**. Although tax shares that are regulated in the Fiscal Equalization Act are recorded directly as tax revenue of the respective public administrative body (recipient), intergovernmental transfer revenues of the **provinces** cover more than half of total income and those of the **municipalities** approximately one-fifth. On the expenditure side, it becomes evident that essentially the federal level (co-) finances services that are offered by other public bodies: province-employed teachers, investment contributions for residential housing, environment and infrastructure, federal contributions to finance hospitals, reimbursements for the transfer of federal highways to the provinces, demand allocations according to FAG 2005 (Fiscal Equalization Act), grants for sewage disposal and water supply (residential water management). In 2007 total transfers between and within the federal government, provincial governments, municipalities, and social security funds amounted to approximately 38 million euros (that is 29% of total expenditures), of which approximately 26% were accounted for by payments of the federal government. However there are also extensive entanglements between the provinces and municipalities (in each case approximately 3 billion euros). From 2002 to 2007 **intergovernmental transfers** (on the expenditure side) showed a dynamic increase (+5.7% per annum).

- From a **net perspective** of the **intergovernmental transfers** (intergovernmental expenditures minus corresponding revenues) it becomes apparent that in the period under review it was primarily the **provinces** that profited from increased intergovernmental payments, which were mainly rendered by the federal government.

Public Debt according to Maastricht 2007

- **According to Maastricht**, the **national debt** as a percentage of GDP decreased markedly in the year under review. For the first time the national debt fell below the stipulated Maastricht limit of 60% of GDP. The **debt ratio** decreased by 2.6 percent from 61.8% (end of 2006) to 59.2% of GDP (end of 2007) with the reduction being almost completely on the federal government level. In absolute figures in 2007 the **public debt level** rose by 1.9 billion euros and reached 161.3 billion euros at the end of 2007, according to preliminary results (2006: EUR 159.5 billion euros).

- At the end of 2007, the **federal level** accounted for 90.9% of the total national debt, the **provincial level** for 5.3%, the **municipal level** (including Vienna) for 2.9%, social security funds for 0.9%. In 2007 the federal debt as percentage of GDP decreased by 2.5 percentage points to 53.8% of GDP, that of the municipal level by 0.1 percentage points to 1.7% of GDP und that of the social security funds by 0.2 percentage points to 0.5% of GDP, while the debt ratio at the provincial level rose by 0.1% to 3.1% of GDP.

- The creditor structure of the public debt is dominated by the creditor structure of the federal debt. The federal government covers its financing requirement mainly by 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 2007 the share of **foreign debt** reached about 80%. The Austrian banking sector is the most important **domestic creditor** of public debt (end of 2007: 11%). At the end of 2007 **private investors** (enterprises and private households) held only about 1% (about EUR 1.5 billion.) of the total public debt by direct ownership of government securities. Indirect ownership of government securities of private households through investment funds amounted to over 2 billion euros at the end of 2007.

7.2 The Federal Government's Debt Activities in 2007

- The **debt of the federal government (excluding own holdings of federal securities)** reached 147.4 billion euros at the end of 2007 and thus was 2.1 billion euros above the comparable value of the previous year or 1.5%. Measured against GDP, the debt ratio of the federal government decreased noticeably in the year under review (end of 2007: 54.0% of GDP; end of 2006: 56.3% of GDP).

- Since mid-2007 **financial markets** have been marked by considerable turbulences. The "flight to secure investments" as well as revised growth expectations have put a halt to the interest rate rise on markets for government bonds, which continued until the middle of the year. The effects of the crisis in confidence were not only apparent from the fact that the yield curve for government bonds in the euro area was pushed downward, but also by an inverse course evident in particular in the short-term segments of the yield curve. Nevertheless at 4.3% the yields of 9- to 10-year

Austrian government bonds were approximately 50 basis points above 3.8%, the yields of the previous year.

- The **yield difference** between German government bonds and Austrian government bonds widened as a result of financial market turbulences. In 2007 on an annual average basis, the yield difference to Germany was 7 basis points for 10-year bonds (2006: 2 basis points). Similar yield differences to Germany were observed in most of the EEA countries, with the exception of Greece, Italy, and Portugal, whose yield differences to Germany were 19 to 27 basis points (Euro-12-average without Luxemburg 2007: 12 basis points).

- The federal government's debt management once again made use of the nominal interest rate level on euro capital markets, which was higher in 2007 but still relatively low, by concluding **long-term financing at fixed interest rates**. In 2007 gross borrowing had an average maturity of 14.3 years (2006: 11.9 years). Once again **euro government bonds** were the principle source of financing. In January the Republic of Austria issued, among other types of bonds, a 30-year bond with a coupon of 4.15%, which was increased in the course of the year to a volume of more than 5 billion euros. In 1997 a bond with a maturity of 30 years was issued for public subscription for the first time and for the last time until 2007.

- The **structure of the federal government's debt (excluding own holdings of federal securities)** in Austria shifted further towards euro debt forms. At the end of 2007, 82.4% of the federal government debt was accounted for by euro bonds (2006: 79.7%) and 95.1% by all types of euro debt (2006: 94.3%). The **share of foreign currency debt** of government debt (after swaps) decreased on the year before from 5.7% (end of 2006) to 4.9% (end of 2007). The volume of foreign debt expressed in terms of euros (after swaps) amounted to 7.3 billion euros at the end of 2007.

- Once again, **interest rate swaps** were used extensively. At the end of 2007 interest rate swaps reached a nominal value of 38.2 billion euros (2006: 28 billion euros). In 2007 these swaps were mainly used to approximate an interest payment profile (in cash or according to federal budgetary law) to the actual yields or to curb the effect of interest rate losses in the federal budget as a result of bonds that were issued under par.

- In 2007 the **foreign debt ratio of the federal government** again showed an increase, which was mainly due to the fact that **euro** debt securities of the federal government were acquired by foreigners. If the 10% share owned by the federal government is not taken into account, foreign primary dealers acquired almost 99% of the volume of government bond issues in 2007.

- The average **remaining maturity of the total debt portfolio** rose more sharply in 2007 than in the previous year. At the end of 2007 the average remaining maturity was 9.1 years and thus was 1.0 year above the remaining time of the previous year.

- In 2007 the average **nominal interest rate** of the federal government's financial debt was reduced in spite of a significant increase of the remaining maturity (+1.0 year) and a slight increase in the market interest rate level, from 4.4% (end of 2006) to 4.3% (end of 2007). This development was triggered by a substantial redemption of debt categories with a much higher nominal interest rate of up to 7.25%. At the end of the year under review, 96.6% of the outstanding obligations of the federal government were **fixed-interest-rate obligations**.

- In 2007 the expenditure component **interest payments for debt** (without own holdings of federal securities) decreased by 278 million euros (2007: 6.64 billion euros; 2006: 6.92 billion euros) in spite of a net deficit of 2.9 billion euros on the previous year. In 2007 refinancing had to be effected at a higher market interest level than in 2006, but at the same time debt categories with higher nominal interest rates in comparison to the present interest level fell due. If the budget component **"miscellaneous expenditures"** ("other costs") is incorporated in this figure, **the federal debt servicing costs** totaled 6.76 billion euros (2006: 6.85 billion euros). It was the first time since 2000 that expenditures of the budget component miscellaneous expenditures were above those of miscellaneous revenues.

- If the development of interest costs of the federal government debt is compared with national key figures the following can be seen: **interest expenditure** for debt is a significant expenditure of the federal government, but a decrease in its burden on the budget is also evident. In 2005 there was an increase in the **interest-to-tax ratio** as a result of the Tax Reform 2004/2005 to 17.0%. This ratio decreased to 15.5% by 2007. In 2007 the **interest-to-GDP ratio**, which is measured on economic performance, was 2.5% of GDP. In 1999 the interest-to-GDP ratio was still at 3.3% of GDP.

7.3 Conclusions

- On the whole, due to unexpectedly high revenues of the general government in 2006 and 2007 it would have been possible to reach the targeted goal of a balanced budget in Austria. However, in 2007, at 0.1 % of GDP, the target of the **budget surplus agreed upon by the provinces (including Vienna) in the Austrian Stability Pact 2005** of 0.7% of GDP definitely seems to have been missed. Overall in 2007 **growth of expenditures** of the general government, which were at 3.5% on account of a special effect (purchase of military equipment), can be considered relatively moderate. However, measures set by the federal government in 2007 will not have any significant budgetary effect before 2008.

- Without **programs to curb the dynamism of expenditures** (in particular in the area of health services) and without a **comprehensive state reform program** that reinforces the responsibilities of the individual levels of government, and facilitates structural reform programs that increase efficiency and also the agreed-upon reduction of personnel (Administration Reform Program II), the **postulated goal of a balanced budget of the general government through the whole economic cycle** is not likely be achieved **on a sustainable basis**. The urgent need for reform in fields of mixed responsibility of all levels of government that in most cases are characterized by little transparency of performance, quality and costs, such as in health care, is documented by above-average increases in expenditures. The consolidation measures taken so far by provincial hospitals (e.g. cooperations, concentration of services, closing down of hospitals, an achievement-oriented payment system) have not yet led to any obvious reduction in cost growth. With complex, mostly non-transparent systems of responsibility, decision-making and financing, it is almost impossible to allocate responsibilities and the incentive to use financial means economically is very low.

- The consolidation course agreed upon in the present **Austrian Stability Program** (November 2007) to achieve a **midterm objective of a balanced budget in Austria** (average decrease of the structural budget deficit in the period under review by 0.2 percentage points p.a.) cannot be classified as particularly ambitious in view of the positive favorable economic conditions (measured by output gap and/or GDP growth rates that exceed trend growth). To achieve the medium-term budgetary objective (MTO) set by the federal government of a balanced budget of the general government throughout the whole economic cycle, annual consolidation measures (cyclically adjusted and not including one-off measures) in the range of 0.5% of GDP should be set in line with EU-obligations.

- In an **international context Austria** ranks midfield with a budget deficit of 0.5% of GDP in 2007 and a debt ratio of 59.1% of GDP. [1] In the framework of a very favorable economic situation, 11 of the 27 EU members have already recorded budget surpluses.

1 GDP ratios have been calculated with GDP figures from June 2008 with the exception of international comparisons (figures from March 2008). In 2007 Austria's debt ratio thus exceeded the debt ratio as compared to international standards by 0.1 of GDP.

- In connection with the **"quality" of public finances** in the context of the Lisbon Strategy, it can be seen that in the years 2003 to 2007 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. In this connection principally the increasing cost of health care (in hospitals and in private practices) are reflected. Direct expenditures of the government for **investments** have been losing significance for years. Additionally it does not seem that the volume of public investments including spun-off entities of the state and finance leasing has increased. **On the revenue side** in the period under review, at first the weak economy and the Tax Reform 2004/2005 had an adverse effect on tax revenues. However, later, tax revenues increased dramatically in the course of the economic recovery. In 2007 the clearly declining course of the **tax ratio** (tax and social security contributions compared to GDP), came to a standstill. In 2007 at 41.9% of GDP Austria was above the average tax ratio of the Euro-15 countries whose ratio was 40.8% of GDP.

- **Administrative outlays** of the general government (compensation of employees, intermediate consumption), which most recently accounted for 28% of total public expenditures, showed an above-average rise in the period under review (2003 to 2007) of 3.7% per annum. This development is not surprising, as the personnel expenditures and the goals on the number of personnel agreed upon in 2005 (**Administrative Reform II**: reduction of personnel expenses 2006 to 2010 by 1.9 billion euros or by 15,667 FTE) was not put into effect and spin-offs according to the ESA 95 have lost significance in recent years.

- A **very low level of interest sensitivity** of budget-relevant **interest cash flow** is evident from the structure of the federal government's debt. By extending the duration (midterm capital binding) of its debt, which was already high on an international comparison, in the past few years conditions on the capital market, which are favorable from a historical perspective, were set for a longer time period, or more specifically hidden reserves were created. However a **long duration** accompanied by an increasing (normal) yield curve boosts budgetary expenses of a debt portfolio. The positive refinancing effect (replacement of debt categories with high interest rates by those with lower interest rates) will decline in 2008. The planned debt rescheduling of the federal government (net deficit: 3.0 billion euros) combined with the extremely low interest rate sensitivity of the debt portfolio (long duration, high fixed-interest components) is not expected in 2008 to increase interest expenditure of government debt even if the market interest rates continue to rise.