
SUMMARY OF THE STUDY:

**SPIN-OFFS OF
AUSTRIAN MUNICIPALITIES:
EXTENT, RANGE OF SERVICES
AND RISK POTENTIALS
(RESULTS AS OF THE END OF 2010)**

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1. SUBJECT OF THIS STUDY

On the backdrop of budgetary restrictions in the past years, **shifting investment-related tasks of municipalities to infrastructure and real estate enterprises** has increased. It seems as if these municipal enterprises – in addition to enterprises with market-determined activities that are recorded in the budget – for the most part have now taken over providing municipal infrastructure services. Data on this off-budget sector have hardly been available up to the present, although in most cases there is still a close connection to the municipality as proprietor and financier. As a result of this shifting of public services to organizational forms under private law, implicit obligations can arise for the municipality due to (off-balance sheet) debt of the spun-off enterprises. In order to obtain similar funding conditions, a municipality usually assumes liability for the repayment of borrowed capital of the off-budget company. In addition, there is a tendency for spin-offs to increase the operating risks in providing services (e.g. as a result of complex contracts and limitations of intervention rights of municipalities and municipal supervisory bodies). On the other hand, it can be assumed that forms of organization under private law can react more flexibly to market developments and that, due to competition, services can be provided more efficiently.

The **main section** of this study on **Spin-offs in the Sector of Austrian Municipalities** is based on a **survey of the Government Debt Committee** (made on a voluntary basis), covering the following topics:

- **Significance** of municipal spin-offs in Austria in which the influence of the municipality dominates (including number of spin-offs, organizational forms),
- **Range of services** of spun-off units in municipalities (including scope of activities and investment volumes) as well as
- **Risk potential** of spin-offs for the municipalities (among other things, arising as a result of off-budget debt, inadequate management of holdings).

Spin-offs in the sense of the present study (or the survey) are understood to be independent units that fulfill municipal tasks and are controlled by the municipality (in terms of ESA 95). **Municipality associations and joint administration bodies for local government units** were not considered spun-off units in this questionnaire survey. However, at present, comprehensive **data** are neither available on municipality associations and joint administration bodies for local government units nor on municipal enterprises - **in the framework of official statistics**.

The study at hand also includes the following three supplementary subjects:

- **Previous findings** on the subject of spin-offs in municipalities,
- **Regulatory issues of local government supervision** assigned to the provincial level and
- Reasons for the choice of specific **legal forms for spin-offs**.

In the following, conclusions on the basis of the results of this study will be presented and additional fields of research on the subject of municipal spin-offs will be outlined.

2. MAIN RESULTS AND CONCLUSIONS

2.1 Volume of extra-budgetary Debt and Investments relatively high

- Evidence from information available so far **about extra-budgetary municipal enterprises** suggests that, **for the first time**, the results of the present study provide adequate **indications** of the **scale** of the **extra-budgetary volume of debt** and of **extra-budgetary investments** of **municipal enterprises** with dominant municipal influence, considered as a whole.
- The spun-off units with dominant local government influence are mainly **infrastructure units** that provide public goods. The **extra-budgetary volume of investment** of municipal enterprises (excluding Vienna) as assessed in the present study for the year 2010 in the range of EUR 1.2 billion to EUR 1.6 billion was substantial and corresponded approximately to the public investment volume of the local government level (including Vienna) of EUR 1.3 billion, according to ESA 95.
- The **extra-budgetary debt level of municipalities** seems to also have reached a significant scale: The debt level according to Maastricht of the municipalities (not including Vienna) was EUR 4.6 billion at the end of 2010. Thus the debt level of the market-determined enterprises of local governments that were not included in the Maastricht figure (recorded in Sections 85 to 89 of local government budgets, excluding Vienna) had already reached about EUR 7.9 billion at the end of 2010. The results of this study showed an additional extra-budgetary debt level of municipal enterprises (excluding Vienna) in the extent of EUR 7 billion to EUR 10 billion. How many of these spun-off units (and extra-budgetary debts) might be reclassified into the public sector according to ESA 95 and the new ESA 2010 framework cannot be specified.
- It is true that in light of the **small-scale local community structure** in Austria, **more than half of the municipalities with spinoffs** were in the **size class of 500 to 2,000 inhabitants**. However, in 2010, the **level of debt** and **investments** was characterized by the large municipalities and cities with more than 50,000 inhabitants, which recorded a share of more than 60% of the assessed debt and almost 50% of investments. In a **regional breakdown** Lower Austria was the region that especially stood out with a share of more than 30% of projected extra-budgetary total debt. It is also possible, however, that this result might be distorted upwards. In a breakdown by legal form, business partnerships were the main type of legal organization (e.g. KG; GmbH & CoKG; Verein & CoKG).
- In light of their significance (**range of services**, level of **extra-budgetary debt**, and **volume of investment**), **extra-budgetary enterprises** in which the authority of the municipalities dominates have a considerable **influence on the financial situation of the local government level** and the **infrastructure** in municipalities.
- Due to the insufficient quality of data, it was not possible to make any evaluations of the **financial flows** between municipalities and their enterprises.

2.1.1 Spin-offs can contribute to an Increase in Efficiency and Budget Consolidation

- From the **point of view of municipalities**, if units are spun off, specific advantages are that **tax benefits** can be utilized, **business principles** can be reinforced, **planning certainty** or the funding stabilization can be guaranteed, and **the strain on the local government budget** according to **Maastricht can be relieved**. The improvement of the fiscal situation due to tax benefits was shown for a single municipality by means of a sample calculation. However, this study does not include a comprehensive evaluation of the economic advantages of spin-offs.

- In order to take advantage of a **pre-tax deduction** under **private law**, there are **new tax obligations** (e.g. corporation tax) as well as administrative and financial **expenditures for establishing the enterprise and putting it into operation** that have to be faced. Additionally, part of the tax advantage is lost as a result of the value-added tax that becomes due in the first ten years in which the municipality leases back real estate from spun-off legal entities.
- From a theoretical point of view, spin-offs lead to a **boost in efficiency** and **support budget consolidation** provided that they are active in a **competitive environment**. In the case of “quasi-spin-offs” (with extensive interventions of the municipality) in which competition does not play a role, it would be important to scrutinize the advantages and disadvantages of the spin-offs and consider returning the tasks to internal departments of the municipality (“**re-communalization**”).
- Spin-offs can serve as an instrument to improve and to put **communal** and **inter-communal** cooperation into effect. The intention behind pooling communal responsibilities of several municipalities to a common spun-off unit or including enterprises in a holding company is to create **synergy** and to reinforce **professionalism** and **know-how**. Local governments play a prominent role in providing numerous services. Many municipalities are confronted with the necessity to consolidate their budgets structurally and thus for the long term. Inter-communal co-operation and so-called **shared service centers** are of central importance in this context.
- In the past, the local-government level (including Vienna) made a positive contribution to **the fiscal balance** of the general government according to Maastricht) – among other things also through spin-offs. In the crisis years 2009 and 2010, the deficit was kept at a relatively low level and was mainly determined by Vienna. The municipalities (not including Vienna) **fulfilled** the requirements of the **Austrian Stability Pacts** in the period from 2001 to 2008. In several provinces the municipalities were able to transfer surpluses to the provinces.

2.1.2 In many Spin-offs the Municipality still retains Intervention and Monitoring Rights

- The **right of the municipality and municipal supervisory bodies** to intervene and monitor is a **conflict area in corporate law**. In order for the municipality and municipal supervisory bodies to maintain the right to intervene, specific measures are required in deciding on the **choice of legal form** and how the **enterprise’s articles of association are phrased**. For example, the management board of an AG (public limited company) acts without any intervention and according to the Austrian Stock Corporation Act (Aktiengesetz) intervention and monitoring rights are only held by the supervisory board (Aufsichtsrat), whereas with a GmbH (private limited company) shareholders have the possibility to issue instructions.
- According to our survey, the municipalities were intent on **maintaining the right to intervene** in spun-off enterprises. As a rule, they were successful because they chose the appropriate legal form (specifically KG (limited partnerships) and GmbH (private limited company) models) and also due to how the articles of association were structured. In this way, the monitoring and auditing bodies (advisory boards, committees) retained **democratically legitimized set-ups**. However, as a result of spin-offs, it has become **more difficult to create a meaningful dataset** about the municipalities.
- To what extent **public service objectives** and **politico-economic matters** of municipal representatives leave their mark in the management of spun-off enterprises was not surveyed in the questionnaire. But the meager affirmative answers of both of these objectives “reinforcing autonomy” and “avoiding restrictions of performance” are a sign that, though municipal enterprises constitute an **independent, legal construction, to some extent**, they actually continue to function as a government unit (local government).
- It appears that there is need for improvement in the **strategic holding management** of municipalities (in particular the smaller ones). It is true that, as a rule, there are **reporting and docu-**

mentation requirements to the municipality and the municipalities (including the municipal council) have the right to review the enterprises. Additionally, as a rule, **decision-making processes** in the framework of holding management are organized in a **standardized** form that is **legally binding**. However, **strategic investment management** with **medium-term agreements** is very rare (more likely in cities) or non-existent.

- By making use of **advisory services**, **provinces** are increasingly attempting to make contributions – as a rule through **municipal supervisory bodies** – to improving the quality of municipal budget controlling and, by making use of funding allocations, to avoiding and to overcoming budgetary emergency situations and also to funding and investment planning. Additionally, as a result of provincial laws, it has become evident that efforts are being made to ensure that **municipal supervisory bodies** also **maintain** the right to **wield power and influence**.

2.1.3 Financial and Institutional Risks of Spin-offs

- **The municipal supervisory bodies of the provinces** do not seem to be fully aware of the **financial situation** of the municipalities including off-budgetary units. Research on the eight municipal supervisory bodies of the provinces revealed that spun-off units and their financial structure have only been recorded systematically in individual cases or only in partial sections. In order to support the **municipal supervisory bodies** in meeting their tasks, it would be necessary in future to strive for a more **systematic recording** of the **off-budgetary areas of municipalities**, and for a more thorough **evaluation** of the **risks** that occur as a result of municipal spin-offs.
- **Budgetary risks** for municipalities caused by the **off-budgetary debt** of enterprises arise specifically when debt servicing **cannot be covered by the proceeds** of the enterprises or by the service charges agreed upon with the municipality and/or when the municipality **is liable** for the obligations of the off-budgetary unit. Although, if necessary, **selling assets** to cover obligations of the enterprise is possible in principle, in the case of **infrastructure facilities**, such as official buildings, schools, day-care centers, construction yards, etc., it would be politically sensitive and could be difficult due to a lack of demand (special properties). In addition, the municipality would subsequently have to provide for alternatives (e.g. buildings in neighboring towns).
- In the present study only the **shifting of municipal expenditures and responsibilities** through **outsourcing** have been analyzed. Special or other forms of “outsourcing”, such as **operating companies, public-private-partnership projects, or leasing arrangements** were not a subject matter of this study. These represent other practiced variations used in providing infrastructure services on the municipal level. From the point of view of the authors, considerable **risks** are attached to all “forms of outsourcing” due to **complex contract constructions** that should be linked to comprehensive **advisory services** to the municipal supervisory bodies and transparent contractual **conditions including approval requirements**.
- **Recent legal** (national and international) **requirements** will make it harder in the future to take advantage of tax benefits and to have spin-offs approved. First of all, with the First Stability Act of 2012 **pre-tax deduction will no longer be possible**, as long as the lessee of a leaseback of property of a spun-off legal entity is not entitled to a VAT deduction in its own right. This applies to public corporations (Körperschaften öffentlichen Rechts) such as municipalities. In addition, the **criteria** used to **classify units with close ties to the government** in the private sector according to ESA 95 are being made more precise and intensified by Eurostat. The **new ESA 2010** that is expected to become effective in 2014 is likely to reinforce this development. The results of the study cannot be used to derive a scale of extra-budgetary debt that might be reclassified into the public sector according to ESA 95 and ESA 2010.
- **Taking advantage of tax benefits** is utilized on **all levels of government** (e.g. preliminary tax deduction, exemptions from corporate tax, tax on land and buildings, tax on acquisition of land, or municipal tax, etc.) and, in the opinion of the authors, this point requires a critical analysis, in particular if the tax revenue of a third party is lowered due to this **tax loss** and if profiting from

the tax advantage is accompanied by additional **operational risks** (e.g. legal risks).

- The process of improving fiscal monitoring in the EU (economic governance) involves the **need for action** in order to fulfill transparency and governance requirements in Austria. According to the EU Budget Directive, among other things, **contingent liabilities** (including legal liabilities, non-performing loans, and **liabilities** arising from activities of **public corporations**, including information about their extent) must be disclosed. The **Austrian Stability Pact 2012** is in line with the reporting requirements (debt levels of municipal real estate enterprises, newly established units as well as the volume of debt for which the municipalities have assumed liability) with the exception of “information on the participation of general government in the capital of private and public corporations” (COUNCIL DIRECTIVE 2011/85/EU). However, there are still methodological issues open (e.g. types of guarantees, direct and/or indirect liabilities and definition of “extra-budgetary entities”). Statistik Austria is stepping up measures for a systematic survey of spin-offs in local and provincial governments. However, no time has been determined to publish this data. From the current perspective, the availability of off-budget data is not expected before 2014.

3. ADDITIONAL FIELDS OF RESEARCH

The study at hand is the first to provide evidence on the magnitude in the area of spun-off units in which there is a dominant influence of the municipality (not including Vienna). These projected results of the questionnaires for the year 2010 provided information on the third column of government activities and/or activities carried out with close ties to the government, which, in addition to the municipal level according to ESA 95 and market-determined enterprises (Sections 85 – 89), are to be taken into account, and which influence the overall picture of the local government level. On the basis of these results, the following **additional fields of research** could be dealt with. Specific points that these fields include are:

- Budget situation of **municipal associations** and **administrative communities** as well as **spin-offs of the municipality of Vienna**,
- Evaluation of the available information starting with the year 2011 in the field of **debts for which repayment is guaranteed by the municipalities** and **the debt level of real estate enterprises according to the Austrian Stability Pact 2011**,
- **Systematic compilation on the local government level of all government sectors and those with close government ties**, including a clarification of conceptive and material classification issues (e.g. regarding gross and net debt level or in the areas of municipal associations),
- **Interdependencies** between the **government sector** and **units with close government ties** (e.g. effects of spin-offs on the budgetary and debt situation of municipalities).