SUMMARY OF THE 2014 ANNUAL REPORT

Weak economic activity in Austria and declining country risk premiums in 2014

- Real GDP in the **euro area** returned to a moderate growth path in 2014, posting a year-on-year change of +0.9% (Eurostat data). The economic recovery that had commenced in 2013 lost some momentum in the first half of 2014, but picked up speed again in the second half of the year.

- The **Austrian economy** lost its growth advantage over the euro area in 2014, which it had previously maintained for many years, and continued to report weak activity, as it had already done in 2013 (real GDP in 2014: +0.3%). The economic expectations evident at the beginning of the year were not fulfilled as exports provided no real growth stimulus and domestic demand developed weakly.

- The rise in **payroll employment** was not strong enough in 2014 to absorb the increase in labor supply. The number of registered unemployed persons went up by 32,200. The **Austrian unemployment rate** (national definition) rose to 8.4% of all persons in payroll employment (plus the registered unemployed); the unemployment rate according to the Eurostat definition came to 5.6% of the total labor force and thus remained among the lowest in the euro area.

- The **decline in yields on euro area government bonds** in the course of 2014 was primarily prompted by **monetary policy measures**: Especially the (first) announcement of a potential asset purchase program in April 2014 resulted in a strong contraction of government bond yields. The **issue yield** for ten-year **Austrian government bonds** reached a historical low in 2014 in average terms (1.3%).

As of 2014 Austria is subject to the provisions of the preventive arm of the SGP

- Since the **excessive deficit procedure** (corrective arm) was **closed** in 2014, Austria has been subject to the provisions of the **preventive arm** of the Stability and Growth Pact (SWP). These generally stipulate the following (in the absence of a derogation):

    - General government deficit below the Maastricht threshold of 3% of GDP.

    - **Adjustment of the structural budget balance** toward the **MTO** (medium-term objective) of –0.45% of GDP. According to the European Commission, Austria therefore needed to reduce its structural general government deficit ratio by 0.6 percentage points in 2014.

    - The **MTO** is also deemed fulfilled if the structural budget balance is within a margin of tolerance of 0.25 percentage points around the country-specific MTO.

    - **Annual (real-term) general government expenditure growth** is to be limited (excluding inter alia interest payments and changes in expenditure for unemployment benefits caused by cyclical developments) to the reference medium-term rate of potential output growth, unless the excess is matched by discretionary revenue measures. As long as Austria does not reach its MTO, it must reduce expenditure growth more strongly. For 2014, the (adjusted) upper limit for year-on-year real-term expenditure growth came to -0.1% according to the European Commission.

    - The **government debt ratio** is to be **reduced** in line with the debt rule. Once an excessive deficit procedure has been closed, there is a three-year **transition period**; in the case of Austria this period will extend over the years 2014 to 2016. During these years, the minimum linear structural adjustment provides a benchmark, so as to ensure compliance with the debt rule at the end of the transition period. In this context, maintaining its structural budget deficit for 2014 would be sufficient for Austria according to the European Commission.

- The EU Council's **assessment** of **compliance or noncompliance with the multiple EU fiscal rules** always takes place in the **spring** of the year t for the year t–1 on the **basis of the European Commission's forecast and calculations.**

- If we compare the spring 2015 results of the **potential output estimates** by the European Commission, the Fiscal Advisory Council and the Austrian Institute of Economic Research (WIFO), which are relevant for the cyclical adjustment of the general government budget balance, we find differences, in particular regarding the growth contributions of the trend in total factor productivity (TFP) in 2014. Methodologically, the WIFO – unlike the Fiscal Advisory Council – deviates from the European Commission method, as it assumes a less procyclical TFP trend. Based on a higher TFP trend, the WIFO calculations of March 2015 yield a higher potential output than the European Commission and the Fiscal Advisory Council and, as a consequence, a larger **output gap** (2014: WIFO: –1.5; European Commission: –1.2; Fiscal Advisory Council: –1.0). The 0.2 percentage point difference between the 2014 results of the European Commission and the Fiscal Advisory Council regarding the structural budget balance can in equal parts be explained by different cyclical assumptions (50%) and different data on one-off measures (50%).

- **Overall**, Austria's **fiscal performance** basically fulfilled the **numerical targets** for the year **2014**. However, the debt-to-GDP ratio was considerably higher than planned due to new calculation standards (ESA 2010) and the establishment of Heta Asset Resolution AG, a wind-down unit for Hypo Alpe-Adria Bank International AG. Though the **reform recommendations** issued by the European Commission are broadly in line with the plans of the Austrian government, most structural reforms have not or have only partially been implemented so far. They are to be implemented in the coming years.

General government budget deficit in 2014 smaller than expected; MTO fulfilled according to European Commission

- At 2.4% of GDP, the **preliminary result** for the **Maastricht deficit in 2014** (as at: March 2015) was 0.3 percentage points lower than the target value identified in March 2014 for the year – although economic growth was weak (even weaker than expected).

- A **tendency to overestimate** the deficit at the central government (federal) level at the budget planning stage, followed by stricter budget execution, was observed in previous years as well, with the exception of the year 2012 (unexpected expenditure for the bank support package): From 2005 to 2014, the (planned) Maastricht deficit at the federal level in the respective budget notification of March of the current year was on average EUR 1.2 billion or 0.4% of GDP higher than the preliminary budget result in the finalized accounts of the next year.

- Whereas **temporary effects** in 2013 (bank support package, revenue from the sale of mobile phone licenses, and tax agreement with Switzerland) had resulted in a decrease of the Maastricht deficit by EUR 0.7 billion on balance, such effects **drove up** the Maastricht deficit by EUR 4.0 billion in 2014. On the expenditure side, one-off measures in 2014 included capital transfers to banks (EUR 4.5 billion); on the revenue side, they consisted of repayments of EU tax funds (gross national income-based resource: EUR 0.3 billion) and revenues from withholding tax on capital gains levied in Liechtenstein (EUR 0.3 billion). Excluding these **one-time events**, the Maastricht deficit came to 1.2% of GDP in 2014 and was thus lower than in 2013 (1.5%).

- According to the **spring 2015 forecast of the European Commission**, potential growth amounted to 0.9% in 2014 and the output gap to –1.2% of potential output. Given an assumed budget sensitivity of 0.58, 0.7 percentage points (rounded) of the Maastricht deficit of 2.4% of GDP were attributable to the **cyclical component**. After adjustments for **one-off measures**, the **European Commission spring 2015 forecast** points to a **structural balance** for Austria amounting to –0.4% of GDP in 2014. This means that Austria **realized its MTO in 2014** in terms of its structural budget deficit (maximum value: –0.45% of GDP).

- According to the EU fiscal rules, Austria must comply with this MTO for the general government budget also in the coming years. However, according to the **Fiscal Advisory Council's calculations of May 2015**, Austria might fail to realize this MTO: The **Fiscal Advisory Council** estimates that the **structural budget deficit** will amount to 0.6% of GDP **in 2015** and thus remain **within the margin of tolerance** of 0.25% of GDP around the **medium-term budgetary objective** (MTO). In the **year 2016**, however, the structural budget balance is expected to deteriorate **"significantly"** (in SGP terminology) because of the **tax reform 2015/2016**.

- The **structural budget balance** calculated is subject to **considerable uncertainty**, and previous years' results are frequently **revised**. These uncertainties result from the different calculation methods and economic forecasts, but also from the fact that potential output is not a directly observable aggregate but much rather an analytical indicator. This also explains the different results of different institutions.

2014 increase in government revenues weak by historical comparison, but more pronounced than GDP growth

- The weak economic growth in 2014 resulted in a below-average increase in **general government tax revenues** (+EUR 2.8 billion or +3.1%) compared with the average of the past ten years (+3.3% per annum). Still, the increase in tax revenues was considerably stronger than that of nominal GDP (+2.0%) owing to the **progressive tax rates** on wages and income, the **2014 Tax Code Amendment Act** and **tax increases** adopted in **previous years**.

- The **revenue-based consolidation measures introduced by the federal government since 2011** are likely – on the basis of ex ante estimates by the Federal Ministry of Finance and adjusted for revenue data on certain special taxes, such as the withholding tax on capital gains or the tax on bank liabilities – to have increased government revenues to a total of EUR 4.5 billion up until 2014, which would correspond to year-on-year growth of some EUR 1.0 billion.

- The tax-to-GDP ratio rose further in the reporting year (+0.5 percentage points), reaching 43.1% of GDP in 2014 according to the national definition.

Growth of government spending high in 2014, but distorted by one-off effects

- **General government expenditure** totaled EUR 172 billion in 2014, up by EUR 7.9 billion or 4.8% from 2013. This considerable increase was mainly attributable to **two one-off effects**. First, the revaluation of assets related to the establishment of the wind-down unit Heta Asset Resolution AG caused an **increase in expenditure for nationalized banks** (EUR 2.7 billion). Second, revenue from the sale of mobile phone licenses in the amount of EUR 2.0 billion reduced the expenditure volume in a single instance in 2013 and thus distorted the development of expenditure in 2014 against the previous year.

- If government expenditure is **adjusted for** all **one-off effects**, the year-on-year **increase in expenditure** came to 2.2% in 2014, a value somewhat above the average observed from 2010 to 2014 (total increase excluding one-off measures 2010 to 2014: 2.0% per annum) and above the nominal GDP increase (+2.0%). Austria's (unadjusted) government expenditure ratio rose strongly in 2014 to 52.3% of GDP (2013: 50.9% of GDP).

- In view of the real year-on-year increase of 3.1%, Austria failed to fulfill the EU requirements concerning the **spending rule** for the year 2014 – **a maximum permissible real rate of change in general government expenditure** (adapted) of –0.1% – by a considerable margin, which corresponds to a **"significant" deviation in EU terms**. However, as long as the MTO is complied with, noncompliance with the spending rule does not trigger procedural steps under the SGP. Government expenditure dynamics that are not fully aligned with the spending rule are an indication, however, that it **might be difficult to comply with the MTO** in the future.

Bank support package, social security and healthcare spending responsible for strong expenditure dynamics in 2014

- Revenues and expenditures related to the **bank support package** and with an impact on the budget added EUR 4.2 billion in net terms (2013: EUR 1.4 billion) to the **general government budget deficit (Maastricht definition)** in 2014. **Total expenditure** related to the bank support package ran to EUR 4.9 billion in 2014. This amount was mainly made up by **capital transfers** to Hypo Alpe-Adria-Bank/Heta. On the **revenue side**, there were changes in liability charges for guarantees, interest on loans granted and dividends in 2014; on aggregate, these changes were broadly neutralized, though.

- The rise in **gross government debt** of EUR 11.3 billion in 2014 was higher than the Maastricht deficit on account of the liabilities of Heta (classified under general government sector liabilities) – although repayments of participation capital reduced debt (BAWAG P.S.K. AG, Raiffeisen Bank International AG). Participation capital held by the central/federal government hence contracted to EUR 0.3 billion under the ESA 2010 accounting rules (Österreichische Volksbanken AG). The **debt accumulated** through all bank support measures taken thus far amounted to EUR 27.8 billion at end-2014.

- Next to the **bank support package**, **social security spending** and **healthcare expenditure** have developed comparatively dynamically over the past years. **Social benefits in cash** augmented by 3.2% in the reporting year (+EUR 2.0 billion), primarily because of expenditure on old-age pensions (+3.9% or +EUR 1.6 billion) and unemployment benefits (+4.8% or +EUR 0.2 billion). Though pension-related structural reforms and moderate adjustments of pensions have put a brake on expenditure growth in the area of **pensions**, the increase in spending in 2014 was still markedly higher than nominal GDP growth (+2.0%) and the rise in (one-off effect-adjusted) aggregate spending (+2.2%). The 4.9% growth rate (+EUR 0.6 billion) of **social benefits in kind** can be traced back to **healthcare spending** (+5.0%).

- General government **spending on staff and material resources** grew moderately in 2014 at 1.6% (+EUR 0.9 billion). In 2014, tariff negotiations resulted in a wage increase for federal government employees by 1.9%, following a freeze in 2013. At the regional and local government levels, the negotiated wage increases were higher in some instances. At 1.9%, the increase in spending on staff and material resources at the regional and local levels corresponded to the general government average of the last five years.

- In the past years, nominal **reductions** have as a rule been observed for **interest payments** on general government debt and, on occasion, for **gross capital formation**. The **interest burden** declined by 3.0% or EUR 0.2 billion in 2014 despite the large increase in general government debt. Interest payments reached a volume of EUR 7.8 billion. In 2009, interest expenditure had still come to EUR 9.0 billion.

- Growth in **general government expenditure for gross capital formation** has been low for several years – in part because of **reclassifications to the private sector** (e.g. ASFINAG, municipal utilities, firms that are market producers at the local level), **special financing transactions** (e.g. leasing transactions) and **assumptions of liability**. The substantial changes caused by the new ESA rules applied since the fall of 2014 (**ESA 2010**) have had little impact on these weak spending dynamics. However, the majority of **quasi-public providers of infrastructure** have been classified as **public entities** since the application of the ESA 2010 (e.g. the federal railways' infrastructure provider ÖBB-Infrastruktur, Vienna's public transport operator Wiener Linien, hospitals run by the regional governments, the federal real estate company BIG, real estate companies of local governments), which has resulted in a massive expansion of the investment volume. Based on the new calculation method, public investment reached a volume of EUR 9.4 billion or 2.9% of GDP in 2014.

Austria has low structural deficit and high tax-to-GDP ratio by international comparison

- According to the European Commission spring 2015 forecast, the **structural deficit ratio** in Austria was low in 2014 (–0.4% of GDP), also in comparison with other euro area countries (EA-19 average in 2014: –0.8% of GDP). Some euro area countries posted structural budget surpluses in 2014 according to European Commission data, especially Germany (+1.2% of GDP), but also Luxembourg (+1.6% of GDP), Cyprus (+1.5% of GDP), Greece (+0.4% of GDP) and Estonia (+0.2% of GDP). Structural deficit ratios of less than 1% of GDP were recorded in the Netherlands, Italy and Portugal. The highest structural deficits in 2014 were observed in Ireland (–4.1% of GDP), followed by Belgium (–2.8% of GDP) and France (–2.6% of GDP).

- The **heterogeneous budgetary developments in the various countries** must be seen against the background of their diverging economic situations prior to the crisis, the varying extents to which the countries were hit by the crisis as well as country-specific economic policy stances and international competitiveness. The budgetary situation in Germany and Austria, for instance, had been markedly better than in France and Italy already prior to the crisis.

- By **international standards** Austria has a very high tax-to-GDP ratio. In the EU, only Denmark, France, Belgium, Sweden and Finland posted higher ratios (indicator 4 when taking into account imputed social contributions) than Austria (43.8% of GDP) in 2014. International organizations (European Commission and OECD) especially criticize the high **tax burden on labor** in Austria, which is deemed to have a dampening effect on economic growth. The **tax reform scheduled for 2016** is supposed to reduce labor taxation.

Regional and local governments support consolidation path

- Both Austria's regional and local governments achieved broadly **balanced budgets** in 2014: For the first time since 2003, the fiscal balance at the **regional level** (excluding Vienna) showed a slight surplus of EUR 45 million (0.0% of GDP). A small surplus (EUR 55 million or 0.0% of GDP) was also recorded at the **local level** in 2014. **Excluding the City of Vienna** – whose budget deficit remained more or less unchanged at some EUR 0.1 billion –, **local governments** even achieved a surplus of EUR 0.2 billion or 0.1% of GDP in 2014.

- Although the **consolidation path at the regional level** is firmly embedded in medium-term budget targets and has been accompanied by numerous reform efforts (including administrative reform processes in Upper Austria and measures related to hospital services, e.g. in Upper Austria, Styria and Vorarlberg), it was in particular **(net) intergovernmental revenues** in the amount of EUR 1.0 billion or 0.3% of GDP that contributed to the improvement of the budget balance in 2014. Next to pro-rata **one-off revenues** from withholding tax on capital gains levied in Liechtenstein (+EUR 87 million), these intergovernmental revenues in particular included **additional structural revenues**, which, however, were also tied to additional current expenditure:

    - additional revenue due to the **2014 Tax Code Amendment Act** (+EUR 230 million);
    - earmarked federal subsidies for the expansion of **institutional childcare services** (+EUR 85 million);
    - increase in federal funds for **full-day care arrangements at schools** and for the **new secondary school** initiative (+EUR 55 million);
    - increase in **earmarked subsidies** from the **Pflegefonds** (long-term care fund; +EUR 23 million) to EUR 157 million (net);

- In 2014, all levels of government **fulfilled** the **targets laid down in the 2012 Austrian Stability Pact**. In the case of the central/federal government, expenditure in connection with the bank support package has been excluded in this calculation. The requirements relating to the reduction of the Maastricht deficit have not been adjusted since the 2012 Austrian Stability Pact entered into force, although regional and local governments clearly more than fulfilled the targets as early as in 2012 and 2013.

- In a regional breakdown, **consolidation** (improvement of the budget balance) was most **successful** in per capita terms in Burgenland in 2014 (EUR 103 per person), followed by Tyrol (EUR 32 per person) and Salzburg (EUR 27 per person). By comparison, the per capita balance deteriorated in Vorarlberg (–EUR 133) and in Carinthia (–EUR 87).

- The highest **per capita budget deficits** were reported by Styria (EUR 126), Carinthia (EUR 112) and Lower Austria (EUR 106) in 2014. Vienna (as a regional and as a local authority) also ranked among the subsectors with comparatively low expenditure overruns, with the budget deficit in 2014 coming to EUR 56 per person.

- Upon request by the Federal Minister of Finance, the Austrian Treasury **OeBFA** also provides **financing to third parties** in the name and for the account of the central government. The **central government's total loan receivables** (after swaps) from third-party financing (regional governments, ASFINAG, Theaterservice GmbH, Kunsthistorisches Museum) amounted to EUR 9.4 billion at year-end 2014. This increase is almost entirely attributable to a rise in the stock of central government loans (after swaps) outstanding to the regional governments (+EUR 0.8 billion).

- This type of financing via OeBFA accounted for the bulk, i.e. **about 57.1%**, of regional governments' total **financial debt including Vienna** in **administrative budget accounting** (2014: roughly EUR 16 billion). All regional governments with the exception of those of Vorarlberg and Tyrol accessed this source of federal financing in 2014.

General government debt rose strongly in 2014 due to the establishment of the wind-down unit Heta

- At end-2014, **Austria's gross general government debt (Maastricht definition)** came to EUR 278.1 billion or 84.5% of GDP (end-2013: EUR 261.0 billion or 80.9% of GDP). The **rise** by EUR 17.1 billion consists of the general government deficit of EUR 7.9 billion (primary deficit of EUR 0.1 billion, interest payments of EUR 7.8 billion) and stock-flow adjustments of EUR 9.2 billion.

- The high **stock-flow adjustments** in 2014 of EUR 9.2 billion are to a large part attributable to the debt-increasing effects of the bank support package in the net amount of EUR 7.1 billion (Heta liabilities of EUR 13.4 billion minus the deficit effects of the bank support package of EUR 4.2 billion and the repayment of participation capital in the amount of EUR 2.1 billion). In addition, **ESM** equity payments (EUR 0.4 billion), **EFSF** loans (EUR 0.3 billion) and **period accruals** of interest payments (EUR 0.7 billion) increased government debt. Debt-reducing effects originated from the **repayment of participation capital** (EUR 2.1 billion) and **premiums** from bond issues (EUR 0.5 billion).

- The **increase in government debt** at the federal level of EUR 17 billion observed in **2014** was above all attributable to the establishment of Heta (+EUR 13.4 billion) as a wind-down unit classified under general government. At the local level (including the City of Vienna), debt rose by EUR 0.5 billion, at the regional level, by EUR 0.1 billion. At end-2014, 87.6% of total general government debt was attributable to the **central** government, 7.3% to **regional** governments, 4.7% to **local** governments, and 0.5% to the **social security** funds.

- The volume of measures implemented to **stabilize international and national financial markets** since end-2008 have raised Austria's debt by a total of EUR 37.2 billion or 11.3% of GDP (as at year-end 2014). Of this amount, EUR 27.8 billion are accounted for by measures taken under the **Austrian bank support package**.

- The **share of external debt** in total government debt edged up by one percentage point in 2014, reaching 77.5%. This increase was attributable to the establishment of Heta as a bad bank for Hypo Alpe Adria in the fourth quarter of 2014, among other factors. The overall creditor structure of Austria's government debt is still dominated by the structure of the **federal debt**, which makes up approximately 75% of total general government debt (Maastricht definition) – despite the expansion of the general government sector following the transition to the ESA 2010.

- **Banks** remain the most important group of **domestic creditors** holding claims against the government, even if their role as creditors has been slightly declining since 2011. **Private investors** (enterprises and households) continued to play only a minor role in public sector financing; their direct holdings of securities and holdings of federal treasury bills and notes came to around EUR 1.1 billion (0.4%) of total government debt as at December 31, 2014.

Risk-averse approach determines the federal government financial debt structure

- **Demand** for debt securities issued by the **Republic of Austria** (and via intergovernmental financing also for the Austrian regional governments) was **brisk** on the financial markets in 2014. For a time, Austria even sold **money market papers at negative interest**.

- The spread between **Austria's and Germany's liquidity and risk premiums** for ten-year government bonds contracted in 2014, reaching 25 basis points in annual average terms. The **benchmark yield** for **ten-year Austrian federal government bonds** fell to 1.5% in annual average terms in 2014 (2013: 2%). On June 12, 2015, this benchmark yield amounted to 1.04%.
- The **adjusted federal government debt** (adjusted for own holdings) amounted to EUR 196.2 billion or 59.6% of GDP at the **end of 2014** (end-2013: EUR 193.9 billion or 60.1% of GDP). **Net borrowing by the federal government** in 2014 thus came to EUR 2.3 billion or +1.2%.
- Austria's downgrading from AAA to AA+ on February 13, 2015, by the **rating agency Fitch** did not prompt any significant reactions on the financial markets. Should Austria be downgraded further, however, an increase in government bond yields must be expected according to analyses of the transmission channels for country ratings. The reasoning behind this assumption is that institutional investors are bound by regulatory requirements in relation to credit ratings.
- The **budget targets** defined for government debt management in the budget estimate for 2014 (e.g. balanced repayment profile, liquid reference yield curve for seven different maturities, benchmark targets for the interest-fixing period) were **implemented** in the reporting year. From the year 2015 on, the assessment of compliance with the range of the interest-fixing period will be solely based on year-end values. The adjusted central/federal government debt (adjusted for swaps) at year-end 2014 had a residual maturity of 8.7 years, and 95% of the debt was at fixed interest rates.
- **Interest expenditure on an accrual basis** (**operating budget)** was reduced to EUR 6.7 billion in 2014, representing a year-on-year decline of EUR 0.4 billion. The **reduction in interest expenditure in the operating budget compared with the budget estimate** came to EUR 0.5 billion in 2014; this was almost entirely attributable to the stronger than expected decline in Austrian government bond yields and to the cautious budgeting by the Federal Ministry of Finance. According to the financial accounts and the operating statement, the **federal government's interest expenditure ratio** reached 2.0% of GDP