

7 MAIN RESULTS OF THE AUSTRIAN REPORT ON PUBLIC FINANCES 2008

7.1 Economic Framework and the Fiscal Position of the Public Sector in Austria in 2008

Results for the year under review 2008

- In 2008 financial markets faced **extreme distortions**, which escalated in mid-September. Firms and financial institutions either no longer had important money market and capital market segments at their disposal or the conditions offered were considerably more unfavorable. As a result of these developments in fall 2008, central banks and governments **introduced measures to stabilize financial markets** (easier access to liquidity, lowering of key rates, deposit insurance for account holders, bank recapitalizations) and **applied economic stimulus programs**.
- Admittedly in 2008 the **Austrian economy** grew by only 1.8% compared with the previous year (2007: +3.1%), but it still recorded higher growth than that of the euro area (+0.8%). In the fourth quarter merchandise exports and industrial production fell dramatically. For 2009 a deep recession is also predicted for Austria.
- The sharp decline of economic dynamics in the fourth quarter of 2008 did, however, not have much effect on the Budget 2008. **The results of March 2009 show that in 2008, the year under review**, at 0.4% of GDP **Austria's budget deficit of the general government** was lower than expected and slightly lower than in 2007 (0.5% of GDP). Dynamic economic activity in the first half year and the sharp increase in prices on a time comparison stimulated **the intake of revenues** of public budgets. At 4.6% **total government revenues** reached the third-highest increase within the past ten years (average 1999 until 2008: 3.3% per year). Higher increase rates were only recorded in 2007, the previous year, at 6.0% and in 2001 at 4.8%.
- The **overall tax ratio** (tax revenues of the public sector and actually paid-in social security contributions including EU own resources) increased significantly in 2008. On an international comparison, at an overall tax ratio of almost 43% of GDP, Austria ranked considerably above the euro-16 average of 40% of GDP. Further, in 2008, the year under review, the gap to the euro-16 average expanded by 1.4 percentage points.
- In 2008 at 4.2% **expenditure growth of the public sector was very strong**. This increase rate exceeded the growth rate of the previous year (+3.6%) and clearly exceeded the ten-year average of 2.9% per annum. In this case, in particular, the following points become apparent: the budgetary effects of the measures that had already been resolved before the parliamentary elections in September 2008 (including the 13-month family allowance, the preliminary pension adjustment and one-off payment, the energy grant); the new Fiscal Equalization Act 2008 (including supplemental agreements) that appropriated additional funds for provinces and local governments as well as for hospitals; measures previously resolved in 2007, such as the multiple-child bonus, the Climate Protection Fund and the 24-hour attendance allowance. The **expenditure ratio** did not fall, in contrast to the previous years (2007 and 2008: 48.7% of GDP).
- The sectoral budget balances of public bodies show that the deficit rate on the **federal level** (2008 and 2007: -0.6% of GDP) was not reduced; nor did the budget surpluses of the **provinces and local governments** (2008 and 2007: 0.2% of GDP) increase. The year 2008 was hardly utilized for pending structural measures at any level of government (including public health systems, long-term care, educational administration, pension rights of provincial and local-government civil servants, as well as a constitutional and administrative reform) or for budget consolidation.
- The provinces (including Vienna) are once again not likely to **reach** their stability contributions according to the **Austrian Stability Pact (ASP) 2008** in spite of supplementary revenues. After the Fis-

cal Equalization Act 2005 had already provided additional funds in the amount of EUR 212 million for the years 2005 to 2007, the Fiscal Equalization Act 2008 allowed for a further **(net-) additional income for the provinces and local governments**. When extra-agreed expenditures (24-hour attendance, the guaranteed minimum income, child care) are taken into account, the additional revenues for 2008 amounted to a net EUR +240 million.

- **In the EU area**, the economic and budget environment worsened dramatically as early as 2008 on the backdrop of the financial and economic crisis, so that Austria's budget position improved on an international comparison: In a weighted average, the deficit rate of EU countries exceeded Austria's ratio by 1.5 respectively 1.9 percent. (Austria: -0.4% of GDP; euro 16: -1.9% of GDP; EU 27: -2.3% of GDP). However in 2008 seven of the 27 EU states recorded a budget surplus (2007: 11 EU states).

Midterm development of revenues and expenditures (2004 -2008)

- Within the period 2004 – 2008 with a share of total expenditures of 11% respectively 9% **social benefits in kind to private households** and **intermediate consumption** recorded the highest average increase of 5.5% respectively 5.4% per annum. The development of social benefits in kind reflects mainly the increase in the cost of health care and in long-term care. The increase in the expense category **intermediate consumption** is, among other things, mainly due to, the purchase of military aircraft.
- In the period under review, governmental **personnel expenses** (employee compensation) with a share of 19% of total expenditures recorded an above-average increase of 4.1% per annum. The personnel policy in recent years seems to have turned out to be less restrictive (no Administrative Reform II: reduction of personnel expenses 2006 to 2010 by EUR 1.9 million or by 15,667 full time equivalents) and in addition the policy was accompanied by higher pay agreements and a slight increase in personnel.
- From 2004 to 2008, monetary transfers **to private households**, which tie up around 37% of the total volume of public expenditures, recorded an increase of 3.3% per annum on average, which was slightly lower **than the annual total public expenditure growth** (not including the ÖBB (Austrian Federal Railways) debt relief in the amount of EUR 6.1 billion in 2004) of 3.5%.
- **Direct public expenditures for investments** have been relatively low for years. Gross capital formation most recently recorded a share of total expenditures of 2.1% and an increase in the period 2004 to 2008 of 3.1% per annum. 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 the **public gross investments** (including units that were previously part of the government sector) reach a dimension of more than EUR 5 billion, and are also showing a tendency to increase on the federal level. On the local governmental level the significance of **real estate corporations owned by local governments**, which are assigned to the corporate sector, is likely to increase and the investment volume of the local government level is likely to show a sustainable decrease.
- On the **revenue side**, the Tax Reform 2004/2005 initially reduced tax revenues in the period between 2004 and 2008. However tax revenues later rose steeply as a result of the economic upswing, so that the share of tax revenue of the public revenue increased (2008: 58.3%; 2004: 57.3%). In the period between 2004 and 2008 the **increase in overall public revenues** ranged from 1.2% (2005) to 7.4% (2007) and on average came to 4.7% per annum. In 2008 **total indirect taxes** accounted for 50% of total tax revenues.
- **Actual social contributions** also had a dynamic development (average from 2004 to 2008: +4.4%) on account of rising employment figures and higher contributions. In 2008 the reduction of unemployment insurance contributions for workers in the low-income brackets had a dampening effect on the revenue; however social insurance contributions still rose by 4.9% (Section 3.5.2).

- Although federal taxes shared with provincial and local governments are recorded directly as tax revenue of the respective public entity (recipient) and the Fiscal Equalization Act 2008 (FAG) provided for a shift of transfers to local government taxes, in 2008, **intergovernmental transfer revenues** of the **provinces** covered **48%** (2007: 52%) and those of the **local governments** **17%** (2007: 18%) of the respective **overall revenues**. The intergovernmental revenue share from the **social security fund** was approximately 25%. With a view to the expenditure side, the federal level essentially (co-) finances services that are offered by other public entities (province-employed teachers, investment contributions for residential housing, environment and infrastructure, federal contributions to finance hospitals, conditional transfers according to the Fiscal Equalization Act 2008 (FAG), grants for sewage disposal and water supply). In 2008 total transfer payments between the federal government, provinces, local governments and social security institutions reached approximately EUR 28 billion (that is 21% of total expenditures); of that amount approximately EUR 20 billion was accounted for by payments of the federal government.
- From a **net perspective** of the **governmental payment flow** (intergovernmental expenditures minus corresponding revenues) it becomes evident that from 2004 until 2008, the period under review, it was primarily **the provinces** that seem to have profited from increased intergovernmental payments that were mainly rendered by the federal government.

Public Debt according to Maastricht 2008

- **The public debt according to Maastricht** increased sharply in 2008 as a result of federal-government borrowing for measures to strengthen the equity capital of banks in the framework of the bank-rescue measures starting at the end of October 2008. At the end of 2008 the required Maastricht limit for the overall public debt of 60% of GDP was clearly exceeded at 62.5% of GDP, while in 2007 for the first time in 15 years the **public debt** was slightly below this upper limit (end of 2007: 59.4%). In absolute figures, according to preliminary results, at the end of 2008 public debt reached an amount of EUR 176.4 billion (2007: EUR 161.0 billion).
- At the end of 2008 the **federal level** accounted for 91.0% of the overall public debt, the **provincial level** for 5.2%, the **municipal level** (including Vienna) for 2.8% and the **social security fund** for 1.0%. In 2008 the increase of the public debt ratio was the most evident on the federal government level at 2.8 percent; slight increases in debt of 0.2 and 0.1 percentage points respectively were also recorded on the provincial level and by the social security fund.
- The federal debt dominates the **creditor structure of the public debt**: The federal government covers its financing requirement mainly by issuing euro bonds, which have been acquired almost completely by foreign investors (in particular from the euro area). By the end of 2008 the **share of foreign debt** reached almost 82%. With a share of 9% the **Austrian banking sector** is the most important **domestic creditor** of public debt. At the end of 2008 **private investors** (enterprises and private households) held less than 2% of the overall public debt (2007: 0.7%). The recorded increase of private investors is mainly due to the acquisition of Federal Treasury Notes in the fourth quarter of 2008.

7.2 The Federal Government's Debt Activities in 2008

- At the end of 2008, the debt of the federal government (not including own holdings of federal securities) reached EUR 162.0 billion or 57.4% of GDP (2007: EUR 147.4 billion or 5.4% of GDP) and was thus EUR 14.6 billion or 9.9% above the previous year's figure.
- The very steep rise in public debt in 2008 by EUR 14.6 billion or 9.9% (2007: EUR 2.1 billion or 1.5%) is due to three special factors. First of all, **additional borrowings** of EUR 8 billion were required in order to be prepared for the resolved **rescue measures** of the federal government for recapitalization of banks (granting loans, acquisition of company shares in the amount of up to EUR 15 billion). However by the end of 2008 banks had only accessed EUR 900 million, so that reserve appropriations in the amount of net EUR 6.7 billion were recorded in the federal budget. Secondly **shifts in the area of financial assets** of the federal government took place, by which the government's **hold-**

ing of own securities (mainly government bonds) was reduced by EUR 4 billion on a year-to-year basis. Additionally for the first time since 1999 once again **accounting foreign exchange losses** in the considerable amount of net EUR 1.3 billion were **recorded**, which also increased the level of financial debt.

- At the end of 2008 the **foreign-debt share** of the financial debt (after swaps) amounted to 4.9% and did not change on a year-to-year basis. In 2008 the federal government was not funded exclusively in the form of euro debt, but foreign currency purchases were transferred in the course of derivative transactions (cross-currency swaps and forward foreign exchange contracts) to euro-debt categories.
- The **three-month interest rate** on the money market (EURIBOR) increased by October 2008 by more than 60 basis points from 4.5% to 5.1% and afterwards by the end of the year fell to an interest rate of only 3.3% in the course of the liquidity and confidence crisis that had come to a head on financial markets. In 2008 the European Central Bank lowered the minimum bid rate from 4.25% to 2.50%. Starting with August 2008 **yields of government bonds** in the euro area decreased on the backdrop of very high volatility. **The secondary market yield of the federal government** (in the 10-year range) was 4.3% on an annual average and corresponded to the previous year's value.
- The **yield difference** of German government bonds to Austrian government bonds in the 10-year term segment widened dramatically as a result of financial market turbulences. In the second half of 2008 the yield difference rose to as much as 81 basis points (December); however this development was not a specific Austrian phenomenon. On an annual average at 29 basis points, the yield difference of Austria to Germany was less than those to other countries in the euro area (euro-12 average not including Luxemburg 2008: 42 basis points; 2007: 12 basis points).
- In 2008 the **federal government's debt management** covered the **financial requirements of the federal government** to a lesser extent than in the previous years by financial products with fixed interest rates and long maturities. This was in light of strong demand for short financial market titles, increased risk spread to longer term funding as well as the expectation of a lowering of interest rates on bond markets as a result of the economic crisis. In spite of a slight orientation toward **money market funding** in the second half of 2008, in connection with interest rate variability and the refinancing risk, the risk-averse basic structure of the debt portfolio of the federal government was retained.
- **Euro federal bonds** whose share of gross borrowing (including swaps) reached only approximately 55% of the total volume in 2008 (2007: about 88%) were once again the primary funding source. However, **Austrian treasury bills (ATBs)** became significantly more important and their share of financial debt (after swaps) increased from 0.4% (end of 2007) to 5.1 (end of 2008).
- In 2008 the average **remaining time to maturity of the total debt portfolio** decreased once again for the first time since 2001, but at the end of the year was still on a high level at 8.3 years. At the end of the year under review, 92.1% of the outstanding debt of the federal government had a **fixed interest rate** (2007: 96.6%).
- The average **nominal interest rate** of the federal government's financial debt decreased slightly once again (2008: 4.2%; 2007: 4.3%). This development was triggered by a lowering of the remaining time to maturity and by a repayment of debt categories with a higher nominal interest rate of up to 6.5%. With a coupon of 5.0 % the euro government bonds tranche from 1998 to 2008, which had the highest redemption volume of almost EUR 8 billion, exceeded the market interest rate level in 2008. At the present time, actual yields are likely to be slightly below the nominal interest rate of 4.2%.
- The increase of the **foreign debt ratio of the federal government**, which essentially was brought about by the purchase of **euro debt securities** of the federal government by foreigners, continued in 2008. This gain was traced to both the purchase of **euro paper** and also **foreign currency debt securities** of the federal government (mainly in the short-term maturity segment). At the end of 2008 the **foreign debt ratio of the federal government** was an overall 82% (2007: 79%).

- **In 2008, the year under review, interest costs for debt** hardly changed at all on the previous year in spite of the very high net deficit of EUR 9.6 billion. A large part of the additional costs for funding the 2008 deficit will not become evident until the interest rate maturity of new debt takes place in 2009. Further, in 2008, debt categories with higher nominal interest rates as compared to the present interest level once again matured, which somewhat reduces the interest burden. If the budget component ‘**miscellaneous expense**’ is incorporated in this figure, then in 2008 **expense for the public debt totaled** EUR 6.70 billion (2007: EUR 6.76 billion).
- **Federal government forecasts for 2009 and 2010** assume that the cost of interest for public debt will rise. Amounts of EUR 7.50 billion (2009) and EUR 7.95 billion (2010) have been budgeted for the cost of interest for public debt (including miscellaneous expenses).

7.3 Conclusions

- **Austria** did not utilize the favorable economic situation and the unexpectedly high development of public revenues in the years **2006, 2007, and 2008** for stronger consolidation, but instead opted for a (sustained) increase in expenditures. The goal of the federal government that was reconfirmed in April 2009 to balance the budget during the economic cycle in Austria would have required a **budget surplus of the general government by 2008** at the latest.
- According to the **Stability Program 2008 to 2013**, the federal government’s planned budget path provides for a steep increase in the **budget deficit of the general government** in 2009 and 2010, which will not be reversed until 2012. This course reflects, on the one hand, the weak recovery of the economic environment (on average +0.8% per annum), and on the other hand, the numerous measures to revive the economy as well as expansions of services in the fields of home care, pension and family benefits. The development of the **structural budget deficit** 2009 to 2013 is shaped by the permanent nature of numerous fiscal measures resolved from 2007 until 2009 as well as by areas of expenditure, which in the past were marked by a high annual increase and are in line to be reformed.
- The worldwide **financial and economic crisis** presents an **unusual circumstance** in terms of the stability and growth pact (serious slump), which allows the deficit of the general government to exceed 3% of GDP **temporarily** if it is **close to the reference level**. However the financial and economic crisis does not override either the fiscal criteria according to Maastricht or the established correctional measures (excessive deficit procedure).
- **Critical developments on financial markets** including market bottlenecks and volatile market conditions illustrate the **dangers of high refinancing requirements of the public debt**. The refinancing risk of the Republic of Austria is not that capital funding is impossible, but that extensive borrowings must be effected in an unfavorable market situation (high market interest rate with high risk spread and/or a limited product and maturity range). The federal government was able to cover its relatively low funding requirements without considerable difficulties, but it had to accept risk spreads for longer-term funding.
- From the structure of the financial debt of the federal government, it can be concluded that, in spite of an intensified use of money market funding in the year under review, there is a low interest rate sensitivity of the budget-relevant interest cash flow in which market changes are subdued and take an effect on the budgetary interest expense after a long time lag. The new high borrowing of the federal government that is to be expected in combination with the financial and economic crisis speaks for a strong risk-averse direction of the federal government’s debt management in connection with the refinancing risk and interest rate sensitivity of the debt portfolio (long duration, high fixed interest rate component).