Main Results of the Austrian Report on Public Finances 2005[1]

Economic Framework, the Fiscal Position of the Public Sector and the Central Government's Debt Activities in Austria in 2005

Economic Framework and the Fiscal Position of the Public Sector in Austria in 2005

- In 2005, the **Austrian economy** showed a real growth of 1.9% compared with the previous year (2004: +2.4%). It therefore showed a growth rate considerably above that of the euro area of 1.3% (2004: +2.0%). In comparison, the growth of the global economy was 4.8% (2004: +5.3%), according to the IMF. In Austria, this growth was supported by both exports and domestic demand which progressively increased in importance during 2005.

- The increased risks for price stability caused the ECB council to increase the **key interest rate** – for the first time since October 2000 – towards the end of the year. The minimum bid rate for main refinancing operations was increased by 0.25 percentage points and, at the end of the year, was 2.25%. The **money market interest rates** developed closely parallel to the key interest rates. The **long-term bond yields** in the **euro area** showed a downward trend in the first three quarters of 2005 and increased, following a historical low of 3.1% in September 2005, to 3.4% at the end of the year. In the middle of the year, long term bond yields lay 70 basis points below the level of the previous year. The **yield curve** became visibly flatter during the year 2005.

- In the year under review, the **budget deficit for the general government of Austria** will be considerably less than expected. The estimations of the Federal Ministry of Finance assumed a budget deficit of 1.9% of the GDP whereas the results of Statistics Austria from March 2006 show a negative budget balance of only 1.5% of the GDP for the year 2005. This encouraging develop-

---

[1] Source: Staatsschuldenausschuss, Bericht über die öffentlichen Finanzen 2005, Vienna 2006 (English version of chapter 7).

ment can be traced back primarily to higher-than-expected taxation revenues which the central government partially used to reduce its budget deficit. Compared with the previous year, the budget deficit of the general government was increased mainly by the second stage of the taxation reform 2004/2005 and lay 0.4 percentage points of the GDP above the value of the previous year of 1.1% of the GDP.

- In 2005, despite the comprehensive taxation reform, the **revenue of the public sector** increased somewhat more strongly compared with the economically weak years 2002 and 2003. Compared with the previous year, the taxation amount of the administrative public bodies in the representation of the European System of National Accounts (ESA 95) increased by 0.7 billion euros or 1.1% (2004: +2.4 billion Euros or +3.7%; 2003: +0.3 billion Euros or +0.5%). The **provinces** showed a relatively high increase in the development of their **taxation and transfer revenues** totalling 4.0% (2004: +1.6%). In particular, revenue from transfer payments of the central government and the social security funds showed a dynamic development. In contrast – according to provisional data – the 3% increase in the taxation and transfer revenues of the **municipalities** (including Vienna) was considerably lower than that of the previous year (2004: +6.1%). The taxation revenue of the **central government** increased by 0.9% in 2005 (2004: 3.4%).

- On the one hand, measures taken in the previous years to brake the dynamism of expenditures (pension reforms, administration reforms, stricter budget controlling) helped on the **expenditure side**. On the other hand, the public budgets were burdened by measures taken in the previous years to stimulate the economy and promote growth (packages to stimulate the economy 2001/2002, Growth and Competitiveness Package 2003, initiatives to support research activities). The **programmes passed in the year under review** to increase employment (“Apprentice Initiative”, “Regional Employment and Growth Initiative 2005/2006”, “Law for Enhanced Employment Prospects 2006”) will, to a large extent, only make an impact on the budget after 2006. In 2005, above-average expenditure increases could be observed for **intermediate consumption** (including rentals) and social benefits in kind (hospitals, above all) as well as in the **gross investments** of the state. The costs for **active civil servants**, in accordance with the ESA 95 (payments to the employees including actual social security contributions and imputed pension contributions), showed a comparatively dynamic development of +3.3% in 2005. This is a reflection of the somewhat higher salary adjustment as well as a (probably) slight increase in the personnel of the public sector.

- In the year 2005, the **total revenue of the general government** amounted to 118.2 billion euros or 48% of the GDP and the **expenditures** reached 122.2 billion euros or 49.6% of the GDP. Measured against the average for the past five years, the total revenue of the state demonstrated a growth of 2.2%, as a result of the improved economic situation and the delaying effects of the taxation reform 2004/2005, which was slightly above the average for 2001 to 2005 of 1.9% per annum. The total increase in the state's expenditure, amounting to 3.0%, also exceeded the 2.7% average of the previous five years. The **tax ratio of the general government** (taxation revenue including actual social securities contributions in % of the GDP) decreased by 0.7 percentage points of the GDP to 42.0% of the GDP in the year under review and came close to the 40% ratio targeted for 2010 (2004: 42.7% of the GDP; 2003: 43.1% of the GDP).

- The **sectoral distribution of the budget balances** in Austria shows a revised view of the budget development at the level of the provinces. At the end of March 2006, the Statistics Austria (in accord with Eurostat) altered the ESA 95 accounting of **loans made by the provinces for hospital financing**. The granting of loans by the provinces to cover the deficits of their hospital enterprises will no longer be evaluated as a financial transaction but as Maastricht-effective subsidy financing. This new interpretation decreases the positive budget balance of the provinces by 0.1% of the GDP for each of the years 2001, 2002 and 2004, and by 0.4% of the GDP for 2003. The **budget surplus at the level of the provinces** of 0.2 billion euros or 0.1% of the GDP was extremely low in 2005. In addition, this slight budget surplus is exclusively the result of the chambers of the provinces whereas, in the narrow sense, they themselves (without Vienna) probably only achieved a balanced budget.

Compared with the previous year, 2005 showed a deterioration in the budget balance for all public administrative bodies. The **deficit of the federal sector** increased from 1.4% of the GDP (2004) to 1.7% of the GDP (2005) and the **surpluses of the provinces and municipalities** seem to have decreased from 0.3% of the GDP (2004) to 0.2% of the GDP.

- If one analyses the **structure of public expenditure**, one is confronted with the following picture: more than 60% of the state's expenditures are used for transfers to third parties (social benefits to private households and subsidies to enterprises), almost 30% for the production of public goods and services (salaries and wages, material expenses) and approximately 6% for interest payments on the public debt. Only around 2% of the total expenditure is used for investments (gross investments). In the **period from 2001 to 2005, intermediate consumption,** with a portion of around 9%, showed the largest increase of 5.4% per year. This can be attributed to the dynamism in the spin-off area (rental payments to the real-estate enterprises of the public administrative bodies), leasing activities, new EDP systems, as well as higher maintenance costs and energy prices. Compared to this, **staff remuneration**, with 19% of the total expenditure, showed only a moderate increase of 2.7% per annum. **Transfer payments** (to private households and enterprises) increased by 3.2% and 2.5% respectively per annum and interest payments for the public debt decreased by an average of 2.3% each year.

- With 3.0% per annum, the **gross investments** of the state showed a relatively strong increase in the period from 2001 to 2005 starting, however, from a low level. Institutional changes in the state sector in 2001 (spinning-off of hospitals and market-like services on the central and municipal level (Federal Real-Estate Company (BIG), water supply, sewage disposal, garbage disposal, housing, congress halls)) led to a definite decline in public investment in the sense of the ESA 95. If one adds the investments of the spun-off entities to the **state's investments**, the **gross investment of the state (including spin-offs after 1997)** reaches a magnitude of 5 billion euros with an increasing nominal trend (2005: 5.5 bill. Euros or 2.2% of the GDP; 2001: 4.9 billion euros or 2.3% of the GDP). In 2005, the increase in gross investments (including spun-off entities) of 4.3% appears to be relatively significant. In this case, investments at the municipal level, in particular, increased. Here, it must be observed that leasing financing (operating leasing) is entered as an intermediate consumption and not as an investment.

- **Taxes and social security contributions** play a crucial role, on the **income side**, in financing public spending. They cover 90% of the revenue of the state. Additional sources of finance are **"production profits"** (including payments for hospital services, nursing homes and communal public utilities), the state's **"assets income"** (interest, dividends, license payments) as well as **"transfers"** (education fees, court fees) which, measured at their respective ratios of 3% to 4%, are of comparatively little importance.

- Although there are more than 100 different **tax categories** in Austria, ten categories account for 90% of the direct and indirect taxation revenue. The largest single tax is the **value-added tax** which makes up around 30% of the total tax revue of the state. **Wage tax** plays a similarly important role in connection with taxation revenue and accounts for almost 60% of direct taxes and almost 30% of the total taxation revenue. In 2005, 53% of taxation revenue was made up of the sum of indirect taxes.

- There are close connections between the four sub-sectors of the state which is empirically demonstrated by the high volume of **intergovernmental transfers**. Although the tax ratios of the individual public administrative bodies, regulated in the Financial Equalization Act (FAG), are entered as tax revenue for the individual legal entity, the **intergovernmental transfer revenues of the provinces** cover more than one half, and those of the **municipalities** around one fifth, of the respective total income. The federal contribution to pensions results in an intergovernmental revenue ratio of more than 25% for the social security funds. If one investigates the **expenditure side**, it becomes clear that the federal level essentially (co)finances services which are provided by other public legal entities (teachers in the provinces, transfers for housing development, environmental purposes and infrastructure, the federal contribution to hospital financing, compensation for transferring federal roads to the provinces, undesignated funds in accordance with the FAG 2005, subsidies for sewage disposal and water supply (water sector).

- In a **comparison over time**, the extremely dynamic **flow of intergovernmental payments** becomes apparent. Intergovernmental transfers (on the expenditure side) expanded by 6.7% per annum between 2001 and 2005. This is an indication of the increasingly complex financing network of the public budgets in Austria and the need for a reform to disentangle competences and financing within the public sector. The dynamism of these transfer flows is further increased by the fact that areas of responsibility are continuously spun-off from the individual budgets and performed by own sub-units (funds, associations and other entities). There is no change in this picture when only payment flows between the sub-sectors (central government, provinces, municipalities, social security funds) are considered.

- According to preliminary results, the **debt level, in accordance with Maastricht**, reached 155.1 billion euros at the end of 2005 – and increased by 4.5 billion compared with the previous year (2004: 150.6 billion euros). Measured against the GDP (end of 2005), it was possible to reduce the debt ratio by 0.7 percentage points of the GDP from 63.6% (end of 2004) to 62.9% of the GDP (end of 2005). Deviating from the Eurostat findings, if one neglects **intermediary financing by central government for public entities** which, from an economic viewpoint, should be included in the private sector, at the end of 2005, Austria had only failed to satisfy the Maastricht upper limit of 60% of the GDP by approximately one percentage point of the GDP (end of 2005: 151.2 billion euros or 61.3% of the GDP).

- At the end of 2005, 90.7% of the total national debt fell on the **federal level**, 4.4% on the **level of the provinces**, 3.8% on the **municipal level** (including Vienna) and 1.1% on the **social security funds**. Looking at the **individual sectors** in the current report, one notices that, compared with the previous years, the classification of the liabilities and/or receivables of a sub-sector of the state (central government, provinces, municipalities, social security funds) has been altered towards a net debt concept (financial liabilities minus financial intergovernmental assets). The **classification according to sectors for the intergovernmental liabilities and/or receivables** is now made from the point of view of the creditor and not the debtor. This means, for example, that the central government's financing of the provinces within the framework of intermediary financing of legal entities is represented as a debt and that federal bonds in the possession of other sub-sectors decrease the debt of the investor (e.g. the social security funds) and not that of the central government.

- The overall picture of the **creditor structure of the public debt** has been dominated by the distribution of ownership of the federal debt and the parameters in existence since the implementation of the EMU. In the seven years of the EMU's existence, the portion of **debt owned by foreign creditors** has increased from 48% (end of 1999) to 74% at the end of 2005. This displacement of the distribution of ownership can be traced back primarily to the purchase of **federal bonds** by foreign investors. The central government satisfies its financing requirements, to a very large degree, through the emission of bonds which are almost entirely purchased by foreign investors (from the euro area, in particular). The Austrian **banking sector** still forms the most important **domestic creditor** of the public debt even though this has, once again, decreased (end of 2005: 13%; end of 1999: 27%). At the end of 2005, **private investors** (enterprises and private households) were only in direct possession of securities covering around 1% (approximately 1.5 billion euros) of the public debt. However, the importance of private household as creditors of the state becomes somewhat greater when one takes the indirect ownership of government bonds included in investment funds into consideration. At the end of 2005, this amounted to around 2.5 billion euros.

- **To summarize**, it can be determined that, in an international context, **Austria's fiscal position**, with a budget deficit of 1.5% of the GDP at the end of 2005, stands out positively and, in view of the economically weak years 2001 to 2003 and the taxation reform 2004/2005, can be regarded as relatively low. However, without programmes to curb dynamic expenditures, particularly in the health-care sector, and to increase efficiency in order to realize the concerted reduction in personnel (administration reform II) while maintaining the level of services, the goal of a balanced budget for the general government until 2008 hardly appears possible. When dealing with the **"quality" of the public finances**, it can also be asserted that the taxation and duties measures of 2005 (second stage of the taxation reform 2004/2005, increase in the pension and health insurance contributions) contributed to indirect taxes and social security contributions gaining in importance on the income side and that the tax-to-GDP ratio (taxation and actual social security contributions measured against the GDP) decreased comparatively strongly (2005: 42.0% of the GDP; 2004: 42.7% of the GDP). If one includes the investments made by the spun-off entities, which were formerly part of the public sector, with public investments, it would appear that the increase in gross investments (including spun-off entities) of 4.3% in 2005 was relatively pronounced.

The Central Government's Debt Activities and the Creditors' Structure in 2005

- The **debt of the central government** (without own security holdings) reached 141.3 billion euros at the end of 2005 and, thereby, lay 5.8 billion euros or 4.3% above the comparable value of the previous year of 135.6 billion euros. Measured against the GDP, the level of debt of the central government hardly changed (end of 2005: 57.3% of the GDP; end of 2004: 57.2% of the GDP).

- The **percentage of foreign currency debt** in the total debt (after swaps) decreased over the year from 9.7% (end of 2004) to 8.2% (end of 2005) as financing in foreign currency has greatly decreased in attractiveness since the establishment of the euro financial market. The central government still does not finance its needs exclusively in the form of euro borrowing, but almost all foreign currency borrowing was transferred into euro categories by way of swaps (cross-currency swaps and interest swaps). De facto, **revaluation gains** hardly had any effect on the level of foreign currency debts (unrealised net gains: 2005: 0.02 billion euros).

- The extremely low nominal interest level on the euro capital markets at the beginning of the year – which further decreased until September – was used by the debt management of the central government to conclude **long-term financing with fixed interest rates** as possible. In 2005, the gross borrowings had, on average, a very long time to maturity of 15.0 years (2004: 10.6 years). **EUR federal bonds** were, once again, the principle source of financing and their percentage of the gross borrowing (taking swaps into consideration) amounted to around 75%. Extremely long times to maturity of up to 30 years were obtained by bank loans and structured financial products. However, the central government's structured financial products (index-linked bonds, inflation-linked bonds, etc.) were converted into standard products by the debt management through hedging operations (cross-currency swaps, interest swaps, forward exchange operations).

- The **yield difference** to German federal bonds, which have the "benchmark status" in the 10-year maturity segment, was extremely slight in the year being reported. In 2005, the average difference in returns to Germany's 10-year bonds amounted to 2 basis points (2004: 5 basis points). Most other EMU states also demonstrated a similar difference to Germany (EMU average 2005: 3 basis points; 2004: 6 basis points – without Greece and Luxembourg).

- In 2005, **the structure of the central government's debt in Austria** moved further towards euro forms. At the end of the year, 77.0% of the debt of the central government was in **EUR federal bonds** (2004: 77.2%) and 91.8% of **all types of euro debts** (2004: 90.3%). The portion of euro **credit and loan contracts** increased in 2005 for the first time since the mid-1980s and, at the end of the year, amounted to 12.2% (2004: 11.3%) as financing, with extremely long times to maturity of up to 30 years, was carried out primarily in the form of **promissory note bonds** with fixed interest rates. Contrary to some other states in the euro area, no bond emissions were chosen for this long-term segment but – in addition to federal obligations – primarily loan-taking. The **euro debt** (after swaps) increased by a total of 7.3 billion euros or 5.9% to 129.7 billion euros.

* In the year under review, 2005, **no (or almost no) new financing** was taken out **in foreign currencies** for the second time in succession. A comparison with the relevant framework on the capital markets (interest level, interest differential between currencies, investor structure, liquidity, range of products) spoke in favour of the euro financial market and against taking on any additional exchange rate risk. The **volume of foreign currency liabilities** (taking own holdings and currency swap contracts into consideration), converted into euros, was 11.6 billion euros at the end of 2005; 1.5 billion euros below the value for the previous year of 13.1 billion euros. The portion of Swiss francs in the foreign currency debt increased from 59.5% (2004) to 61.8% (2005) where the Japanese yen decreased to the same degree.

* The establishment of the EMU changed the **investor structure in the central government's debt** decisively. As a result of the euro financial market, foreign financial intermediaries took on the role previously held by Austrian financial intermediaries as the main investors in the central government's debt. The issuing volume of federal bonds in euros (including intermediary financing of public entities and 10% own holdings) reached the level of 16.3 billion euros in 2005. If one ignores the percentage retained, foreign primary dealers took on almost 97% of the volume of federal bond emissions in 2005 (2004: 99%). In addition, a comparatively high amount of promissory note bonds in euros were finalized with financial intermediaries in the euro zone. At the end of 2005, **foreign investors** (particularly from the euro area) financed over 70% of the total federal debt (in euros and foreign currencies).

* The already historically low interest level at the beginning of the year decreased further during the year speaking in favour of intensifying financing with **fixed interest rates over a long term** in order to maintain the low interest costs over a period as long as possible. Thereby, the central government's obligations with fixed interest rates (taking interest swaps and own holdings into consideration), increased significantly by 8.0 billion euros or 6.2%, whereas the debt with varying interest rates (including half-variable interest) was reduced (2005: -2.2 billion euros or -28.1%). At the end of the year under review, 96.0% of the outstanding debts of the central government had **a fixed**

interest rate (2004: 94.2%). The **average remaining time to maturity** was 7.6 years at the end of 2005 or 1.2 years above the value of the previous year.

- In spite of an increase in the time to maturity of 1.2 years, the average **nominal interest rate** of the central government's debt decreased from 4.8% (end of 2004) to 4.6% (end of 2005). The development was the result of substantial repayment of debt categories with a much higher nominal interest rate of up to 7.5%. In 2005, the market interest level was lower than in the previous year and this also supported this development. However, the interest level of the total debt of the central government, which is valid at any given time, has only a limited impact on the average nominal interest rate due to the high portion of the debt with fixed interest rates and the use of linear bonds.

- **In the year under review, 2005**, the expenditure component **"interest costs"** for the debt increased markedly when compared with the previous year (2005: +0.43 billion euros; 2004: +0.06 billion euros). This is a reflection of the central government's remission of claims on intermediary financing of the public entities of the SCHIG (Railroad Infrastructure Company) and the OeBB (Austrian Federal Railways) which increased the interest payments of the central government by around 275 million euros. The additional interest resulting from the central government's net deficit in 2005 could be partially compensated for by the fact that a large number of debt categories with higher nominal interest rates than is currently the case became due and new financing was taken out at a lower market interest rate. If one includes **miscellaneous expenditures**, the costs for the **debt totalled** 6.47 billion euros in 2005 (2004: 6.23 billion euros). In 2005, the budgetary component "miscellaneous expenditure" was, once again, lower than "miscellaneous revenue".

- If one compares the interest costs for the central government's debt with national key figures, it can be seen, on the one hand, that the **interest payments** for the debt represent a significant expenditure item for the national government but, on the other hand, the burden on the budget has, in general, decreased in recent years. In 2005, the **interest-to-GDP ratio** stabilized at 2.6% of the GDP. As a result of the taxation reform 2004/2005, the **interest-**

tax ratio (measured against the net tax revenue of the central government) increased – unlike in the previous years. Interest payments (including miscellaneous expenditures) absorbed 17.0% of the central government's taxation revenue in 2005 (budget section 52 "public taxes"; net tax achievement).

- **Overall**, a very low **level of interest sensitivity** can be detected in the structure of the central government's debt which, in 2005, was further reduced as a result of the shift in the debt-profile towards long-term financing with fixed interest rates. However, the positive refinancing effect (replacement of debt categories with high interest rates by those with lower ones) will probably become noticeably weaker by 2008, at the latest. An **analysis of this interest cost risk** shows that, at the end of the forecast horizon (2013) around 7.3 billion euros of interest costs (net interest payments in chapter 58 without miscellaneous expenditures; normal scenario) are to be expected whereas the risk scenario produces a maximum burden of 8.5 billion euros. A divergence risk of 1.2 billion euros or 40 basis points of the (expected) GDP indicates a low cash flow at risk.