7 MAIN RESULTS AND CONCLUSIONS

7.1 Economic and institutional Framework in 2010

- The **debt crisis in several euro countries** and the developments on financial markets connected with this crisis created substantial challenges for monetary and economic policy in 2010, which resulted in establishing "rescue umbrellas". Concerns about high budget deficits and rapidly growing public debt continue to exist so that a complete normalization of market conditions is not to be expected very soon.
- On May 2, 2010, the **Greek government** agreed upon a **three-year financial aid program** in the amount of a total of EUR 110 billion with the euro countries and the International Monetary Fund (IMF). On May 9, 2010, the ECOFIN ministers came to a consensus on establishing the **European Financial Stabilisation Mechanism** – EFSM, which is entitled to grant loans of up to EUR 60 billion to EU member states. On June 7, 2010, the company "**European Financial Stability Facility** – EFSF" was founded, which can issue bonds amounting to a total volume of EUR 440 billion for which the euro countries bear liability on a prorated basis. All available loans granted by either of these facilities in which the International Monetary Fund is also additionally involved with a share of one-third, as well as the financial aid program for Greece are subject to strict requirements. Subsequently in December 2010 the European Council agreed on establishing the **European Stabilisation Mechanism** (ESM), which will replace the EFSF and the EFSM as of July 2013.
- In order to improve **economic governance** and to avoid debt crises to the extent possible in future, a major change in the **legal framework of the EU** was initiated in 2010. The total package to redesign EU requirements includes three parts and is expected to be completed by summer 2011:
  - **Strengthening the Stability and Growth Pact (SGP)** and its **macroeconomic monitoring**
  - **European Stabilisation Mechanism** (ESM) as a permanent rescue plan as of July 2013
  - **Euro-Plus-Pact** (closer economic coordination of euro countries and non-euro countries on a voluntary basis).
- The procedures to strengthen economic coordination and monitoring in the EU and to implement the Europe 2020 Strategy were linked in the form of the **"European Semester".** On the basis of the "Annual Growth Survey" of the European Commission of January, the European Council determines the most important economic problems in March and gives strategic recommendations on how to deal with them politically. By the end of April at the latest the member states have to present their stability and convergence programs along with national reform programs, taking these Council recommendations into account. By July the European Council and the Council of the European Union (starting with 2011) subsequently make political recommendations to the member states, so that they can be included in the budget plans of the member states (for the following year).
- The **new EU requirements** in the area of **fiscal and macro policy**, which are designed to achieve a **strengthening of the Stability and Growth Pact** and **macroeconomic coordination**, build on the existing guidelines and from today's point of view comprise the following core elements:
  - **Minimum standards for fiscal architecture** in **EU member states** (among other things, more transparency in the budgets of public and quasi-government entities, federal fiscal regulations, budget frameworks with a planning horizon of at least three years, federal monitoring and coordinating mechanisms) that are to be implemented by the end of **2013**.
  - **Strengthening the preventative arm of the SGP** by adding the principle of a prudent budget policy (stricter rules in a favorable economic climate and debt ratios of more than 60% of GDP) and by introducing sanction mechanisms.
  - **Strengthening the corrective arm of the SGP**: Opening the Excessive Deficit Procedure (EDP) can take place not only in case of violation of the deficit criterion of 3% of GDP, but also in case of failure to meet the debt criterion.

- **Stronger automatic action** ("reverse coordination": European Commission recommendation in reference to **sanctions** comes into effect provided the Council does not object by a qualified majority; valid only for euro countries) and a timescale **streamlining of the Excessive Deficit Procedure**.
- **New procedures** to recognize and correct **macroeconomic imbalances** ("Excessive Imbalance Procedure – EIP") for EU member states. The evaluation is carried out on the basis of macroeconomic indicators (e.g. current account balance deficits, a high amount of foreign debt) for which the threshold for warnings is defined ("scoreboard").

- In 2010 **interest rates in EU countries** showed a historically **low level**: The three-month interest rates on the **money market** (EURIBOR) were at 0.7% in January and rose to 1% in the course of the year. Since its historically low point of 2.8% at the end of August 2010, the **10-year interest rate** of the **federal government in Austria** increased to 3.4% by the end of the year (December). The yield increase on bond markets was partly due to the improved situation, but also to the development of risk premiums. The **government-bond interest rate structure** tended to shift higher in the second half of 2010 whereby the rise in the segment for longer terms was more distinctive.
- After the massive downturn of the economy in 2009 in the wake of the global financial and economic crisis, **Austria's economy expanded** again **in 2010**: Real GDP rose by 2.1% on the previous year (2009: –3.9%). Thus domestic economic achievement was very quickly re-approaching its long-term growth path. The upswing in the economy began as early as the second half of 2009 and reached above-average dynamics starting with the second quarter of 2010. In the year under review real GDP reached the level of 2007 at approximately EUR 262 billion.

7.2 Fiscal Situation of Austria in 2010 according to Maastricht

Deficit development as well as the course of revenues and expenditures of the federal government and its sub-sectors

- Federal government intervention to support a lack of demand clearly left its mark on public budgets in Austria: The **budget deficit of the general government** rose in 2010, the year under review, to 4.6% of GDP and the **general government debt** increased to 72.2% of GDP (end of 2010). The additional burden attributable directly to the crisis affected mainly the **federal government level**.
- **In spite of** extensive **statistic overhauls** that increased the deficit and debt level, **in 2010** at 4.6% of GDP (as of April 2011) the **general government deficit of Austria** was almost in keeping with the results that the federal government had predicted (e.g. Budgetary Notification of September 2010: 4.5% of GDP). This slight discrepancy was primarily due to the unexpectedly speedy **economic recovery**, but also due to **conservative estimates** and a **strict budget implementation**.
- In 2010, the rapid economic recovery starting with the second half of 2009 caused **tax revenues to be clearly above expectations**. **Revenues of the federal government** rose in 2010 by a total of 2.5% compared to the previous year (10-year average: +2.6% p.a.) in spite of reductions based on the tax reform of 2009 and at EUR 137.3 billion again reached the pre-crisis level. The revenue ratio fell to 48.3% of GDP (2009: 48,8% of GDP).
- Austria's **overall public tax and contribution ratio** fell in 2010. Nevertheless with a tax and contribution ratio (tax revenues, social security contributions actually paid in and imputed social security contributions including EU own resources) of 43.9% of GDP, Austria was significantly above the euro-17 average of 40.4% of GDP and above the EU-27 average of 39.8% of GDP.
- In spite of **additional expenditures brought about by the crisis** (continuation of economic programs, payments to banks, automatic stabilizers) **public expenditures** increased by 3.5% less than in the years 2006 to 2008 (average 2001 to 2010: 3.6% p.a.). In 2010 almost two-thirds of the **increase in public expenditures** totaling EUR 5.1 billion was accounted for by **monetary social benefits** to private households (e.g. pensions, support in connection with unemployment, minimum guaranteed income) and **asset transfers to market producers** (mainly grants to nationalized banks

to strengthen their equity capital). It can be noted that expenditures that were below those of the previous year were for fixed assets (discontinuation of purchases of military aircraft). Additionally, as a result of the low interest rate level, **no rise in expenditures** for **interest paid** was recorded. In 2010 total expenditures of the public sector reached the amount of EUR 150.4 billion or 52.9% of GDP.

- In 2010 the **public expenditure rate** measured as a percentage of GDP stood at 52.9%. It showed hardly any change on the previous year. In 2010, as in 2009 in view of the decrease in GDP, a significant growth of almost 4 percentage points was recorded. The ratio increase in 2009 illustrated the complex connections between economic performance and the budget.
- In 2010 not only did the budget deficit worsen, but also the **primary deficit** of the **general government** (budget deficit not including interest payments 2010: –5.6 billion EUR or –2.0% of GDP). In 2010 primary surpluses would have been required to stabilize public debt (not including stock-flow effects), as the interest effect that caused public debt to rise cancelled out the growth effect. Economic growth below the average interest rate of the public debt in Austria has been the exception in the past 15 years.
- The **sectoral budget deficits** of public budgets in Austria showed a differentiated picture for 2010: On **the federal level, strict implementation of the budget**, which is being pushed forward by incentive mechanisms in the new budgetary law of the federal government was faced with **higher transfer payments to social security funds** (among others the federal contribution to pensions and reducing health insurance debt) of a net of almost EUR 1.5 billion or 0.5% of GDP as well as flows of funds that increased debt on the basis of the **Austrian Bank Package** of EUR 1.4 billion or 0.5% of GDP. In total, in 2010 the **budget deficit** rose on **the federal level** as well as on the **local government level** in comparison with the previous year, while the fiscal position on the provincial level (not including Vienna) did not continue to worsen (2010: federal level: 3.6% of GDP or +0.4 percentage points, provincial level: 0.7% of GDP, local government level: 0.5% of GDP or + 0.2 percentage points). In 2010 the **expenditure development** on the **provincial level** was **curbed** partially by **one-off effects**, such as for instance in 2009 payments that were carried out earlier than planned to cover the deficits of provincial hospitals. The **deficit increase** on the **local government level** in 2010 (according to preliminary results) was due to the higher priority taken by the **city of Vienna** (budget deficit 2010: EUR 0.6 billion; 2009: EUR 0.3 billion). In 2010 **social security funds** raised their net surplus from 0.1% to 0.2% of GDP.
- **Measures of provinces to stimulate the economy** were calculated by the provinces **(including Vienna)** to be in the **range** of EUR 1 billion annually each for 2009 and 2010. The main portion was probably applied to the area of (pushed forward) infrastructure investments. Extension of guarantees, loan grants as well as construction plans that were carried out by spun-off units, did not have (or did not directly have) an effect on public budgets. The **expenditures for economic programs of the provinces** (not including Vienna) **that** actually **had an effect on the budgets** in 2009 were thus lower and on the basis of estimates (Hauth and Grossmann, 2011) reached a range of EUR 400 million.
- In 2010 the **Bank Package** of the federal government of October 2008 to **stabilize Austrian financial markets** increased net borrowing on the federal level according to Maastricht by 0.5% of GDP. The balance of **current revenues** and **expenditures** from the bank package of 2010 showed a surplus (2010: +EUR 350 million; 2009: +EUR 77 million). In the course of the financial crisis **two banks** (Kommunalkredit Austria AG and Hypo-Adria-Bank AG) were taken over by the federal government. In 2010 these banks received asset transfers (debtor warrants: EUR 1 billion and shareholder grants: EUR 75 million) or parts of the participation capital had to be written off (EUR 700 million).
- On an **international comparison**, at 4.6% of GDP, Austria's budget deficit also remained – in spite of the **EU Excessive Deficit Procedure** – significantly below the average values of the EU-27 (6.4% of GDP) and the euro-17 (6.0% of GDP) in 2010. However, the gap of Austria's deficit ratio to the weighted EU averages shrank markedly (from 2.7 percentage points (2009) to 1,8 percentage points (2010) to the EU-27 countries and from 2.2 percentage points (2009) to 1.4 percentage points (2010) to the euro-17 countries). In 2010 budget deficits below the Maastricht limit of

3% of GDP were achieved by the EU countries Denmark, Finland, Luxembourg and Sweden as well as Estonia, which had a budget surplus.

General Government Debt according to Maastricht 2010

- The **public debt quota according to Maastricht** rose considerably in 2010 in face of the high deficit and special items that increased debt (e.g. bank participation capital, shareholdings of Verbund AG, loans granted to Greece, borrowing to finance residential construction loans, etc.): Austria's public debt level rose by EUR 14.2 billion or 2.6 percentage points to EUR 205.2 billion or 72.2% of GDP. At the end of 2010 the **federal level** accounted for 87 %, the **provincial level** 8%, the **local government level** (including Vienna) **4**%, and the **social insurance funds** 1% of total public debt.
- The **participation capital** (including miscellaneous funding) that was provided by the **Austrian Federal Government to Austrian banks** to cope with the **financial and economic crisis** reached a magnitude of more than EUR 7 billion at the end of March 2011. By March 2011 EUR 1.2 billion had been paid of the **aid measures** agreed upon **for Greece** in May 2010 (lending to Greece in the amount of a total of EUR 2.3 billion). Both of these financial aid measures raised the **public debt level** (however as a rule not the budget deficit). If this financial aid is repaid in 2011 and the following years, the debt level will be reduced again by the same amounts.
- Federal debt shapes the **public debt structure** in Austria: The federal government covers its funding requirements mainly by euro bond issues, which are mainly purchased by foreign investors (in particular in the euro area). In 2010 the share of government bonds held by foreigners fell from 76% (end of 2009) to 75% (end of 2010). The Austrian **bank sector** constituted the most significant **domestic creditor** of public debt with a share of 14%. **Private households** held less than 1% of the total public debt at the end of 2009.
- Although at 72.3% of GDP, on an international comparison, **Austria's debt ratio** (source: EU Commission; stand: May 2011) remained clearly **below the average values** of the euro-17 (85.4% of GDP) and the EU-27 (80.2% of GDP), it considerably exceeded the reference values for public debt according to Maastricht in the amount of 60% of GDP. At the end of 2010, 12 countries of the Euro area had exceeded the 60% limit.

Financial debt of the federal government 2010

- In 2010 **federal debt management** was confronted with complex **market conditions** that had been changing during the time period and that required a prudent strategy, oriented to limiting risk. The triple A rating that has been awarded to the Republic of Austria for a long time contributed to the comparatively favorable refinancing conditions granted to the federal government.
- Compared to Germany, **Austria's liquidity and risk surcharge** for 10-year bonds, which reached the highest value in the course of the financial market crisis at almost 110 basis points (March 2009), was reduced to about 40 basis points in 2010.
- The adjusted **federal government's financial debt** (not including own holdings of federal securities) reached the amount of EUR 176,8 billion or 62.2% of GDP at the end of 2010 and was thus EUR 8.1 billion or 4.8% above the previous year's value. The **share of foreign currency debt** of the adjusted financial debt (after swaps) amounted to only 2.2% at the end of 2009 (end 2009: 3.0%).
- The portfolio of **federal loan receivables** from the **provinces** (Burgenland, Carinthia, Lower Austria, Salzburg, Vienna) rose to a total of EUR 5.8 billion (end of 2009) to EUR 6.3 billion (end of 2010). The increases in Lower Austria, Salzburg and Carinthia were offset in the provinces of Burgenland and Vienna. This **domestic form of financing** of the provinces through the Austrian Federal Financing Agency (Österreichische Bundesfinanzierungsagentur) cleared a substantial portion of the total **financial debt of the provinces** (end of 2009: 70% including Vienna).
- At EUR 25.3 billion (2009: EUR 32.4 billion) the **funding volume (federal government gross borrowing)** was lower than the previous year. **Euro government bonds** once again served as primary financing source in 2010 with an average term of 10.7 years (2009: 9.9 years).

- **In 2010 interest servicing of financial debt (including "miscellaneous expenditures")** fell from a net point of view to EUR 5.7 billion (2009: EUR 6.7 billion) in spite of high new borrowing. The recorded (administrative) interest servicing of the federal government for the financial debt was less than the actual interest expense as a result of one-time items (additional revenues of EUR 1.2 billion due to bonds issued above par). The average **nominal interest rate** of the **federal financial debt** did not change on the year before (2009 and 2010: 4.1%).
- For **2011** in **the federal budget estimate** a **total expenditure** of EUR 7.7 was forecast (2011: **Interest expenditures:** EUR 7.5 billion; **miscellaneous expenditures** EUR 0.2 billion). This amount is likely to be lower, although it is assumed there will be a rise in interest expenses).
- A **very low interest-rate sensitivity** of **interest cash flows** can be derived from the structure of financial debt: Adjusted financial debt (after swaps) has a long period to maturity, more than 8 years, and 96% of the liabilities have fixed interest rates. For **2011** a range of effective duration of 5.0 to 7.0 has been planned.

7.3 Structure and Development of the General Government Revenues and Expenditures 2006 to 2010

- Looking at the **structure of expenditures** of the **general government**, the following overview becomes evident:
  - Public **transfer payments to third parties** (social payments to private households and subsidies to companies) tie up 65% of the **expenditures of the general government**.
  - Less than 30% of expenditures are spent **on the production of public goods and services** (wages and salaries, material costs) and about 5% for **interest payments** on public debt.
  - Only approximately 2% of total expenditures are spent (directly) on **gross capital formation**.
- The **increase** in **expenditures of all public budgets** (general government according to ESA 95) in Austria was at about an average of 4.3% p.a. in the period under review, 2006 to 2010, and thus above nominal GDP growth.
- **Transfer payments to market producers** (subsidies and investment grants with a total share of expenditures of 12%) showed the highest increases at 5.3% p.a. on average in the period 2006 to 2010. In this connection the largest expenditure areas were **health care** (mainly the inpatient care; provincial hospitals) and **transport** (quasi-government entities of provincial and local governments), which together absorbed more than 50% of the total transfer volume. This expenditure category contains the investment grant for **Austrian Airlines** in 2008 in the amount of EUR 0.5 billion as well as grants to create assets to two **nationalized banks** in the amount of EUR 1.8 billion.
- From 2006 to 2010 **monetary transfer payments to private households** at approximately 37% of government expenditure volume developed analogously to **total public expenditure growth** (average +4.3% p. a.). Monetary social benefits account for approximately 60% of monetary payments of social security funds (mainly pensions) and approximately 20% of pension payments of central, local and provincial authorities. Further important expenditure components are, among other things, family grants, unemployment payments, childcare payments, home-attendance allowance. In particular **benefits according to the unemployment insurance law** and **pension payments** showed an above-average development in the category of monetary transfers.
- With a most-recent share of 18% of total expenditures, **government staff expenditures** (compensation of employees) showed an increase of 3.6% p.a. on average in the period under review. The development of personnel costs seems to have gone hand in hand with a slight rise in government employment in these five years.
- With a most-recent share of 5%, **interest payments** on the public debt rose by only 0.5% in the years 2006 to 2010 in spite of a considerable expansion of debt, due to a decreasing market interest rate level.

- For years **public expenditures** for **investments**, according to ESA 95, have been extremely low. In 1997 and 2001 **spin-offs** caused a significant decrease of public investments (spin-offs of hospitals and market-oriented services on the federal and local levels). Also the **revised recording of ÖBB (Austrian Federal Railways) infrastructure investments** since March 2011 is not reflected in government gross investments, but mainly in transfers to market producers. Additionally the significance of local-government owned real estate enterprises in the private sector is increasing. Also **leasing financing** has taken place on all government levels (according to the Association of Austrian Leasing Companies in the range of EUR 4.6 billion), which as a rule are recorded as intermediate consumption. If one adds those investments to **government investments** that were made by "**previous state-owned units",** then **gross investments of the government (including spun-off units)** reached a range of EUR 6.1 billion or 2.1% of GDP. In 2010 the largest investor remained the **local government level** with a share of 40%.
- On the **revenue side, taxes and social security payments** at over 90% of revenues of the government were a decisive contribution to financing public expenditures. Additional funding sources were **sales** (among other things charges for services at hospital and local nursing homes and local care facilities), **investment income** (interest, dividends, licensing fees) as well as **transfers** (among other things, court fees, guarantee charges, student tuition fees (until 2008)) to the government, which are, however, insignificant measured by their share of about 4% and 3% respectively of total revenues.
- On the **revenue side**, between 2006 and 2010 **tax revenues** were in the range of +7.4% to -4.9% (2009) and on average reached a growth of 2.8% p.a. Initially, the tax reform 2004/05 reduced tax receipts. Subsequently, however, tax revenues rose extremely vigorously until the end of 2008. The financial and economic crisis and the tax reform 2009 led to a marked decrease in tax revenues in 2009. In 2010 an increase of 2.9% was recorded.
- The **actual social contributions** developed dynamically until 2008 as a result of increasing employment and hikes in contributions. In 2009 the slump in this revenue category was not very distinctive as a result of measures conducive to employment and a higher federal contribution to pensions. From 2006 until 2008 actual social security contributions showed increases of more than 4% p.a. In 2009 and 2010 growth fell to 1.2% and 1.9%.
- The total **public revenue increase** stood on average at 2.8% p.a. between 2006 and 2010; a decrease of 2.0% was recorded in 2009 and an increase of 2.5% in 2010.
- There are close connections among the four sub-sectors of the government: Although the tax shares of the individual levels of government that are regulated according to the Financial Equalisation Act are recorded directly as tax revenue of the respective body (recipient) and the Financial Equalisation Act 2008 (FAG) provided for a shift of transactions to collective transactions, in 2010 **intergovernmental transfer revenues** of the **provinces** covered 40% (2009: 45%) and those of **local governments** 15% (2009: 16%) of total revenues. In particular, as a result of the federal contribution to pensions (deficiency guarantees and compensatory allowances), the **social security funds** made up 29% (2010) of revenues of the general government. Additionally in 2010 the federal government made special payments to reduce the deficits of statutory health insurance.
- It is obvious from the **expenditure side**, that in essence the **federal level** (co)finances services that are performed by other public entities (province-employed teachers, investment contributions for residential housing, environment and infrastructure until 2008, federal contributions to finance hospitals, demand allocations according to the Fiscal Equalisation Act 2008 (FAG), grants for sewage disposal and water supply (waste water management)). In 2010 total transfer payments between the federal government, provinces, local governments and social security funds reached approximately EUR 29 billion (that is 16% of total expenditures); of that amount approximately EUR 21 billion was accounted for by payments of the federal government. Since 2008 **federal transfer payments** to **social security funds** have risen dramatically, which also reflects the expansion of services in the social insurance area (e.g. increasing home-attendance care funds, high and advanced adjustment of pensions in 2009, changes in the special retirement scheme for manual workers and long-time insured persons ("Hacklerregelung").

7.4 Conclusions

- In the **crisis, fiscal policy** initially served as an important stabilizing factor on a worldwide basis. The effect of automatic stabilizers, economic stimulus plans, as well as bank bailout measures contributed to curbing the slump in the real economy and financial systems. By spring 2010, however, the budgetary situations in several EU countries had worsened so dramatically that financial markets lost trust in the sustainability of public finances in these countries. Subsequently Greece, Ireland, and Portugal could only meet their funding demands with difficulty or by means of rescue packages.

- The requirement of **consolidation of public finances** in **Austria** increased considerably through the crisis and the accompanying budgetary implications (increase of the public debt ratio, increase of the structural or permanent budget deficit). This was partly due to the fact that the development of a favorable economic situation and the high level of revenues **before the crisis** (2006 to 2008) were not sufficiently utilized for structural reforms to improve the quality of public financing in Austria. In spite of the economic crisis and programs to stimulate the economy, **expenditure growth** of the **general government** was lower in the years 2009 and 2010 at 4.1% respectively 3.5% than in the year 2008 (+4.8%).

- The **national budget goal** that Austria has had for **more than 10 years** of a balanced budget throughout the economic cycle and a structurally balanced budget **has clearly never been achieved** up to the present, in spite of a dynamic development of government revenues throughout several years (especially 2006 to 2008). On the backdrop of the high public debt in Austria and the unstable international environment, the economic necessity of a budget policy that is oriented to stability with the goal of a **balanced budget throughout the economic cycle** should be beyond dispute. High public debt restrains **budgetary leeway** and casts doubt on the **long-term sustainability** of the budget of a government. The unstable international situation is contributing to high-risk aversion on financial markets, which can rather quickly trigger a negative debt-interest spiral.

- The **strong risk-averse direction** of the **federal debt management** with respect to refinancing risk and interest-rate sensitivity of the debt portfolio in consideration of cash (long duration, high fixed interest components) has remained.

- In the framework of the **excessive deficit procedure** ECOFIN has placed Austria under obligation to gradually **reduce** its **public deficit ratio** starting with 2011, which also will involve **lowering its debt ratio.** Additionally, the required **(structural) fiscal adjustment** has been set in the amount of **¾ percent of GDP for the years 2011 to 2013.** The development of the (structural) budget deficit and the debt in the **present Austrian stability program** do not take sufficient account of these EU demands. Although, according to the present stability program, the deficit ratio will be reduced to approximately 2% of GDP by 2014, the consolidation course planned until 2013 is not sufficient to lower the debt ratio. The reduction of the structural budget deficit in the years 2011 until 2013 is approximately an average of 0.3% of GDP p.a. instead of 0.75% of GDP p.a.