1. MAIN RESULTS AND CONCLUSIONS OF THE GOVERNMENT DEBT COMMITTEE PUBLIC FINANCE REPORT 2011

1.1 Economic and institutional Framework in 2011

- **In the reporting year 2011** the monetary and real economic development in the euro area was characterized by **public debt crises** in several countries of the euro area: Other subject matter, such as the more favorable world-wide economic outlook, had only a brief influence on market activities. The European Central Bank reacted with a series of **special monetary measures** (including the Securities Markets Program and a one-year tender). In the face of increasing distortions, **heads of state and government** of the EU took steps toward a stronger fiscal union and ultimately arranged for a restructuring of Greece's debt payment in combination with an aid package.

- The **tight market conditions** led to a growing yield gap. An ever-increasing number of core euro-area states experienced **sales pressures** on the bond market, in particular, in the **third quarter of 2011**.

- **Governments on all levels** in **Austria** still were able to cover their **funding requirements** at **very low costs** in 2011**:** In January three-month-interest rates on the **money market** (EURIBOR) stood at an average of 1.0% and in December at 1.4%. At an annual average of 3.3% and a volatile course during the year, the **10-year interest rate** of the **Federal Government** was scarcely higher than in the previous year (3.2%). The historical low starting at the end of August 2010 at a yield of 2.8%, once again continued to fall to 2.7% in September 2011. The **government bond interest structure** showed a tendency to shift downward, with the decrease most noticeable in the long-term segments.

- In 2011 the **Austrian economy showed** a very strong **expansion**: real GDP rose by 3.1% on the previous year (2010: +2.3%) and thus reached a growth rate that was distinctly above the long-term average (real GDP growth (1995 – 2011: +2.1%). In comparison, in 2011, the momentum of **European economic performance** slowed on the previous year (2011: +1.5%; 2010: +1.9%).

- The **change** of **fiscal governance** in the EU was laid down in the framework of **three legislative packages**:

    - **"six pack" of the EU:** stricter fiscal rules in **SGP,** directives on **national budgetary frameworks** and **macro-economic surveillance**. They became effective in the form of five EU regulations and one directive on December 13, 2011.

    - **Fiscal Compact** as an **international law treaty** ("Treaty on Stability, Coordination, and Governance in the EMU") between 25 heads of state and government of the EU to strengthen **budget discipline on a national level**.

    - **draft regulation** on **budgetary control** of **euro countries** including synchronized monitoring and assessment of national estimates **("two-pack"** – EC **draft** from November 23, 2011).

- Particular emphasis should be put on the following aspects of the **features of the reform** of the new SGP and the directives on **domestic budgetary frameworks**:

    - Within the preventative arm of the SGP budget rules of the **structural budget deficit** (structural deficit reduction of 0.5% of GDP p.a.) and the **expenditure rule** (real expenditure growth below that of the potential growth rate) complement each other. If **revenue elasticity is less than 1** (as, for example, is normally the case in Austria), it can be assumed that the **structural budget rule** has precedence.

- Under normal circumstances, applying **the debt rule** does not require any additional need for consolidation, **if** the **adjustment path to achieve MTO** according to EU legal rules is **adhered to** and the **nominal GDP** expands by at least 3% p.a.
- **Complying with fiscal rules** is to be accelerated by a stronger **automatic process** (EC proposal relating to sanctions becomes effective unless the Council opposes it by a qualified majority) and by a **schedule tightening of the procedure** in cases of an excessive deficit.
- **Minimum standards for fiscal architecture in EU member states** (among other things, more transparency in the budgets of public units and units with close government ties, national fiscal regulations, budget frameworks with a planning horizon of at least three years, national monitoring and coordinating mechanisms) are to be implemented by the end of 2013.
- In the case of **exceptional occurrences** that have a significant impact on government finances, all fiscal EU rules provide for stipulations that allow **a temporary deviation from budget rules.**

- The **Fiscal Compact** tightened the **regulations of the "six pack**" in that **strict translating** of the **EU guidelines into national law** has become obligatory. It is stipulated in this treaty that the EU requirements of a **structurally balanced budget** (lower limit of –0.5% of GDP) are to be implemented by the member states on a national level in a manner that is legally binding and permanent. In addition, member states must set up an **automatic corrective mechanism.** This treaty will become effective as soon as twelve member states of the euro area have ratified it. Adoption of the Fiscal Compact is a prerequisite for utilizing the permanent rescue mechanism ESM.

1.2 The Fiscal Position of Austria in 2011 according to Maastricht

1.2.1 Development of the Deficit as well as Revenues and Expenditures of the General Government and its Subsectors

- In the year 2011 in Austria the **budget deficit of the general government** was dramatically reduced (–1.9 percentage points) (2011: 2.6% of GDP; 2010: 4.5% of GDP). This (unexpected) **high reduction in the year 2011** took place on the backdrop of the dynamic economic expansion in Austria and is a first step toward a **structurally balanced budget**. The **cyclically adjusted budget deficit of Austria** (or the **structural deficit** not including one-off effects) was also at 2.6% of GDP in 2011.

- The "**Loipersdorf Package"** of October 2010 that led to the **Austrian Stability Pact 2011**, the strong growth of the Austrian economy (increase in the nominal GDP: 5.3%), **savings on all levels of government** (**including spin-offs and leasing transactions**) that were not included in the original estimates and the **ESA 95** recording of planned **transfers** to the Hypo Alpe-Adria Bank International AG in the year **2012** played a key role in the deficit reduction of 2011. Also **budgetary incentive mechanisms** to create reserves on the federal level and in several provinces once more supported a strict budget course.

- In the year 2011 **on an international comparison**, at 2.6% of GDP, **Austria's budget deficit** was distinctly below the average values of the EU (EU-27: 4.5% of GDP; Euro-17: 4.1% of

GDP). In addition to Austria, five further member states remained below the reference value of 3% of GDP (Germany, Estonia, Finland, Luxemburg, Malta).

- The extremely **low increase** in **government expenditure** in the year 2011 (EUR +1.5 billion or +1.0%) was achieved in particular by the **reduction of stimulatory measures** and **savings measures** (including spin-offs and a time-lag in expenditures) on all levels of government, but was also due to the non-recurrence of **one-off measures**. For example, in 2011, **lower bank stabilization measures** relieved expenditure growth in the range of EUR 1.0 billion. Taking this one-time effect into account, expenditure growth of the general government turned out to be somewhat higher (+1.6%).

- In 2011 at EUR 4.2 billion or 5.4% **government tax revenue** (ESA 95 basis) showed a very robust expansion (2010: EUR 2.2 billion or 2.9%). The highest increase arose from **direct taxes** and, in particular, mainly from **corporation tax** (+12.1%) and **payroll taxes** (+5.7%). Tax growth was partially attributed to new taxes and tax increases (bank stability levy, air ticket levy, increase in mineral oil tax, etc.) with estimated additional revenue of a total of EUR 1.2 billion for the year 2011, according the Federal Ministry of Finance. In relation to economic output, on a time comparison the **public tax and contribution ratio** fell, due to the strong increase in GDP (public tax and contribution ratio 2011: 47.9% of GDP; 2010: 48.1% of GDP).

- The **fiscal position** of **the government** improved dramatically **on all levels** in 2011: The budget deficit of the **federal level** was reduced by 1.1 percentage points to 2.4% of GDP in 2011, the year under review, that of the **provincial level** (**not including Vienna**) by 0.5 percentage points to 0.3% of GDP, and that of the **local government level** by 0.4% percentage points to almost zero. As a result of lower federal transfers and higher expenditure growth, **social security funds** recorded a slight decrease in their budget surplus to 0.1% of GDP.

- In 2011 on the basis of the **second stage of the Fiscal Equalization Act** (FAG) 2008 (structural) **additional revenues** of EUR 232 million p.a. compared to the first stage of FAG (2008 to 2010) were at the disposal of the provinces and local governments. The **earmarked subsidy** from the **long term care fund** to the provinces to cover the cost increase in the area of long-term care amounted to a net EUR 67 million in 2011. The targeted contribution of the federal government for **expanding child-care facilities** was set in the amount of EUR 10 million in 2011.

- **Expenditure volume on the federal level** (consolidated) even showed a slight decrease in **2011** (EUR –0.1 billion or –0.2%). The total expenditure development was characterized by a decrease in transfers to **market producers** (–5.4%; principally discontinuation of bank support measures), stabilization of the **transfer volume to private households** (–0.4%) and a moderate increase in the field of **material** and **personnel costs** (+1.7%). In addition, **interest payments on the public debt** did not rise significantly due to the extremely low market interest-rate level (2.1%).

- In 2011 **total expenditures on the provincial level** (consolidated) rose very moderately at an increase of 0.8%. Stabilizers in the significant expenditure categories of **material and personnel costs** and the low increase in **transfers to private households** (+1.3%) were mainly responsible for the general development of the year 2011. Also gross investments were considerably reduced (–7.6%). In this connection, it seems that **special effects** (for example, time lapses in expenditures and transition to leasing funding) have also dampened growth increase.

- According to estimate results of Statistik Austria, in 2011 **total expenditures** (consolidated) of the local government level showed a slight decline (–0.3%). This development indicates that **consolidation measures** (e. g. co-operation agreements, savings measures, deferred investments) as well as **special effects** played an important role. Hence the strong decrease in **gross investments in 2011** (–10.5%) may reflect the withdrawal of measures to stimulate the economy, in particular in Vienna, and once again spin-offs and special funding measures (e.g. leasing).

- **Direct expenditures of the government for investments** have been extremely low for years (gross investments 2011: EUR 2.9 billion). The **leasing volume** (especially real-estate leasing used by the provinces) is likely to have reached a scale of at least EUR 4.9 billion in 2011 (2010: EUR 4.5 billion). Based on a study carried out by the Government Debt Committee, the **estimated off-budget investment volume of municipal enterprises (not including Vienna)** reached **a sizable scale** of EUR 1.2 to 1.6 billion in 2010.

- The results of a study on **local government spin-offs** are available in Chapter 10 of the Government Debt Committee report: "**Spin-offs of Austrian Municipalities: Extent, Range of Services, and Risk Potentials – Results as of the end of 2010** (Hauth and Grossmann, 2012)".

- In 2011 at EUR 0.3 billion, the **Banking Package** to **stabilize the Austrian financial market** increased the **public budget deficit** (mainly on the **federal level**) considerably less than in the year 2010 at EUR 1.3 billion. The **expenditure side** of the **federal budget** was once again burdened by payments **to two banks** (Hypo Alpe-Adria-Bank International AG, KA Finanz AG). The **debt level** of the government amounted to EUR 6.7 billion at the end of 2011 due to the Austrian Bank Package.

- For the **year 2012 financial streams that** play a relevant role in increasing the **deficit and debt** are once again to be expected from the **Banking Package**: Payments to **KA Finanz AG** and **Österreichische Volksbanken AG** as well as transfers to the province of Tirol for the **Hypo Tirol Bank** will result in **asset transfers** that **increase the deficit** and will amount to at least EUR 2.3 billion.

1.2.2 General Government Debt in 2011 according to Maastricht

- In 2011 **Austria's public debt** expanded in spite of a considerable deficit reduction of EUR 11.7 billion or 5.7%. The debt level of the government reached a total of EUR 217.4 billion or 72.2% of GDP at end of 2011 (end of 2010: 71.9% of GDP). 87% of the total public debt was accounted for by the **federal level**, 8% by the **provincial level** and 4% by the **local government level** (including Vienna) and 1% by **social security funds**.

- In 2011, the government had a **primary deficit that was almost in equilibrium** (2011: EUR 0.1 billion), which **would have reduced** the **public debt ratio** (**not including stock-flow effects**) – in light of high growth and a low average interest rate of the public debt. Economic growth that is above the average interest rate of the public debt, however, has constituted an exception in the past two decades (most recently: 2005 to 2007).

- In 2011, the increase in public debt was almost EUR 4 billion or 1.3% of GDP above net borrowing according to Maastricht. In this connection, **international measures to stabilize the euro** and **aid measures for Greece**, which increased the debt in 2011 by EUR 1.4 billion and also higher **initial financing for the year 2012** of net EUR 1.9 billion on the part of the federal government played a significant role. As of the end of 2011 **bilateral loans** were granted **to Greece** in the amount of EUR 1.6 billion and loan finance extended through the **European Financial Stability Facility** in the amount of EUR 0.5 billion (rerouting).

- Up to the beginning of the financial and economic crisis, the share of **foreign debt** in Austria's public debt rose steadily to 80%. In the years between 2009 and 2011 the picture changed somewhat, although the interest of foreign investors in federal securities continued to be very high. In the year 2011 the **share of foreign debt** reached a level of 74.8% (end of 2010: 75.2%). It appears that the crisis once again increased the attractiveness of domestic government securities for Austrian investors.

- On an international comparison (source: EU Commission; figure as of: May 2012), at 72.2% of GDP, Austria's debt quota remained significantly below the average of the Euro-17 (88.0% of GDP) and the EU-27 (83.0% of GDP), but it substantially exceeded the reference value of 60% of GDP of public debt according to Maastricht. At the end of 2011 twelve countries of the euro area exceeded the 60-percent limit.

1.2.3 Financial Debt of the Federal Government 2011

- In 2011 federal debt management was confronted with **difficult market conditions** that were changing over the time period.

- On January 13, 2012, the **rating agency Standard & Poor's** (S&P) downgraded the long-term country ratings of nine countries of the euro area (**among them also Austria**) – on the backdrop of increasing risk premiums. Austria **still** has the **best creditworthiness ratings** with **other significant rating agencies** (including Fitch und Moody´s).

- **Austria's interest rate spread** to **Germany** for 10-year bonds rose in November 2011 to almost 150 basis points. This extremely high gap has again been reduced in the meantime, but in June 2012 it was still 88 basis points (annual average 2011: 65 basis points). In 2011 in the euro area only the spreads of the Netherlands and Finland were approximately 40 basis points lower than that of Austria (Euro-12 average not including Luxemburg: 401 basis points).

- The **federal government's "adjusted" financial debt** (not including own holdings of federal securities) reached the amount of EUR 183.2 billion or 60.8% of GDP. The share of foreign currency debt (after swaps) was only approximately 1.4% at the end of 2011 (end of 2010: 2.2%), as liabilities with foreign currency risks were reduced.

- The portfolio of **federal loans receivable** (after swaps) to the **provinces** (Burgenland, Carinthia, Lower Austria, Salzburg, Vienna) rose by a total of EUR 1.3 billion to EUR 7.6 billion in 2011. This form of funding covered somewhat **more than half** of the **financial debt of the provinces** including Vienna as an administrative area (preliminary figure at the end of 2011: EUR 13.1 billion).

- In 2011, the year under review, at EUR 18.9 billion (2010: EUR 25.3 billion), the funding volume (**federal government gross borrowing**) turned out to be low. **Euro government bonds** with an average term of 11.5 years (2010: 10.7 years) served once again as the primary financing source. **Derivative funding instruments** were hardly used at all in 2011 due to the unstable market conditions.

- The **administrative interest servicing** (including **"other costs"**) for financial debt **increased substantially** in 2011 as a result of the lower revenues from above-par issues in comparison to the previous year: It surged to EUR 1.1 billion or 18.8%. Interest servicing of the federal government (including miscellaneous expenditures) reached a total of EUR 6.81 billion. However, compared to the **federal budget estimate** of **2011** – as was also the case in the previous years – the recorded interest servicing was **significantly lower** (net reduced expenditures: EUR 0.88 billion).

- A total expenditure for the interest servicing of the federal government debt in the amount of EUR 7.85 billion was quoted in the **federal budget estimate for 2012**. In this connection, "other costs" for the federal debt is expected to shift from a budget surplus (2011: +EUR 40 billion) to a budget deficit (2012: EUR –0.16 billion), as practically no **above-par issues** were anticipated. Once again a lower (administrative) interest servicing can be expected due to the bond revaluations carried out until the middle of 2012.

- **Starting in the year 2013** the **operating statement** of the **federal budget** will include accruals of interest costs in compliance with ESA 95 norms.

1.3 Structure and Development of General Government Revenues and Expenditures 2007 to 2011 (according to ESA 95)

- If one observes the **structure of expenditures of the general government**, the following facts become obvious:
    - 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.
    - 28% of **expenditures** are spent on the **production of public goods and services** (wages and salaries, material costs) and 5% on **interest payments** on public debt.
    - Only approximately 2% of total expenditures are spent (directly) on **gross investments**.
- Within the period 2007 to 2011 monetary **transfer payments to private households** (monetary transfers, social payments in kind, other current transfers) with a total expenditure share of 53% showed the highest growth at an average of 4.0% p.a. Between 2007 and 2011, in particular, pension **payments** and **government unemployment benefits** showed an above-average development in the category of monetary transfers.
- **The dynamics of social payments in kind to private households** (mainly **long term care** and **health care**) with an expenditure share of 11% showed a considerable leveling off in the years 2009 and 2011. The most recent developments seem to be due mainly to cost-cutting measures in the area of medicinal products and at provincial hospitals. A **comprehensive structural reform of health services**, however, still has not been accomplished.
- In the past years, the development of **transfer payments to market producers** (subsidies and investment grants according to ESA 95) was characterized by **grants to banks** (showing deficit-relevance) in the framework of the Austrian bank rescue measures that were significantly lower in 2011 (increase 2007 to 2011: 3.5% p.a.).
- In the period under review, with a most recent share of 18% of total expenditures, government **personnel expenditures** (employee compensation) recorded a slightly below-average rise of 3.3% p.a. In this category, expenditures of the government for the **education system** were prevalent with a share of almost 40%, followed by **general administration** with a share of 19%. **Expenditures for education as a whole**, measured in terms of total expenditures, had a share of 11% – with a slight progression on the previous year – whereas the expenditure share of **general administration** showed a downward trend at the most recent figure of 13%.
- In 2011, **gross public investments** had a share of 1.9% of total expenditures (EUR 2.9 billion or 1.0% of GDP). If one adds these investments to government investments that were provided by **"previous state-owned units"** (in the past classified as public sector and at present included in statistics), the public investment volume is almost doubled (approximately EUR 5 billion or 1.8% of GDP). The largest investor in 2011 was the **federal government** with a share of 39%, followed by the **local-government level** with a share of 37%. The share of the **provincial government level** was 22% in 2011.
- In the period under review, 2007 to 2011, **interest payments** for the public debt and **gross investments** even showed a slightly **negative course**. During this period, expenditures on interest were curbed by the decreasing level of market interest rates and expenditures on investments by spin-offs and leasing funding.
- The **increase in expenditures of the general government** (consolidated) stood at an average of 3.4% p.a. from 2007 to 2011.

- On the **revenue side, taxes and social security contributions** made up more than 90% of revenues of the government. Further funding sources are **production revenues** (including payments for services), **property income** (including interest and dividend payments) as well as **transfers** (including court fees, guarantee charges, student tuition fees (until 2008)) of the government.

- **Tax revenues** expanded vigorously in 2007 and 2008. In 2009 a distinctive decrease in tax revenues (–4.5%) was then recorded, due to the **financial and economic crisis** and **the tax reform of 2009**. In the following years (2010 and 2011) the tax loss was more than compensated by the buoyant economic situation and new taxes (mainly bank stability levy, CO^2 charge on fuel, air ticket levy). Tax revenues that were at the disposal of the various levels of government in 2011 reached EUR 82.1 billion and thus stood at EUR 2.5 billion above the level of 2007. **Tax revenue** rose on average by 2.3% p.a. in the period under review (2007–2011).

- The slump in **social security contributions** (share of total revenues of approximately 34%) in 2009 was significantly less pronounced – as a result of measures conducive to employment – than the loss of tax revenues. **Actual social security contributions** showed an increase from 2007 to 2011 of on average 3.1 % p.a.

- **Overall growth of government revenue** (consolidated) stood at an average of 2.5% p.a. between 2007 and 2011.

- There are close financial interrelations among the sub-sectors of the government: Although the tax shares of the individual levels of government, which are regulated according to the Fiscal Equalization Act (FAG) are recorded directly as tax revenue of the respective body (recipient) and the FAG 2008 provided for a shift of transactions to collective taxes, in 2011, **intergovernmental transfer revenues of the provinces** covered 39% and those of the **local governments** 14% of the respective **total revenues**. In particular, as a result of the federal contributions to pensions (liability guarantees (Ausfallshaftung) and compensatory allowances), **social security funds** made up 27% of revenues of the general government.

- It is obvious from the **expenditure side** that, in essence, the **federal level** (co)finances services that are performed by other public bodies (among other things province-employed teachers, investment contributions for residential housing, environment and infrastructure (until 2008), federal contributions to finance hospitals, funding allocations according to the Fiscal Equalization Act 2008 (FAG)). In the year 2011 total transfer payments between the federal government, provinces, local governments and social security institutions reached approximately EUR 30 billion (that is 16% of total expenditures); of that amount a sum of approximately EUR 21 billion was accounted for by payments made by the federal government. **Transfer payments** of the **federal government** to the **social security funds** rose dramatically between 2008 and 2010 (increase in long term care fund, high and advanced adjustment of pensions in 2009, changes in the special retirement schemes for manual and long-time insured persons (“Hacklerregelung”), debt reduction of the regional health insurance providers (Gebietskrankenkassen). This momentum leveled off again in 2011.

- There are also extensive **interrelations between the provinces and local governments**, in particular in the areas of social benefits, hospitals, compulsory schools, and residential water management and these interrelations go in both directions. In 2011 intergovernmental transfer expenditures of the provinces amounted to EUR 1.8 billion (according to preliminary data) and those of the municipalities amounted to EUR 2.6 billion. **Government transfers within the subsectors**, for example with funds or associations, which intensify the extent and the complexity of financial interrelations of public budgets in Austria even more, have not been included in these figures.

1.4 Conclusions

- The **year under review, 2011**, with a deficit reduction of 4.5% of GDP (2010) to 2.6% of GDP (2011), could be interpreted as a year in which there was a **trend reversal toward sustainable consolidation** and in which savings potentials on the expenditure side **of all public budgets** were explored and in which there was the goal of a **structurally balanced budget** in Austria. In 2011 the total structural deficit was 2.4% of GDP.

- The **high deficit reduction** and **strong growth** in Austria **in the year 2011** show that the **healthy economic situation** facilitated **budget consolidation** and that the **consolidation measures** implemented by the **government** weakened the economic situation only to a slight extent (growth reduction from 0.1 to 0.3 percentage points).

- The **requirement of consolidation of public finances in Austria** increased considerably due to the crisis and the accompanying budgetary implications (increase in the public debt ratio, increase in the structural or permanent budget deficit). The unstable international situation is contributing to a high-risk aversion on financial markets, which could trigger **negative debt-interest rate spirals** more quickly.

- In the years **2007 to 2011 total expenditures** of all public budgets (according to ESA 95) **grew** by an average of 3.4% p.a. in Austria and were thus distinctly **above the nominal GDP growth** of 2.4% p.a. In this time period expenditure growth was higher in the years 2007 and 2008 than in the crisis years afterward. Not until the reporting year 2011 was growth of government expenditures very low at 1.0% and was significantly below expenditure growth.

- In the year under review, 2011, the robust economic development in Austria – in spite of tax hikes in the course of the "**Loipersdorf Package** "– led to a slightly reduced tax quota. In an international comparison, with a public tax and contribution ratio of 43.5% of GDP (including imputed social security contributions and EU contributions) Austria continued to range **significantly above the Euro 17 average** of 40.7% of GDP (source: European Commission, May 2012).

- The strong **risk-aversion of the federal government debt management**, with respect to refinancing risks and interest-rate sensitivity of the debt portfolio of the federal government in consideration of cash (long duration, high fixed interest-rate components) was continued in 2011.

- From the **fiscal point of view**, the following three implications concerning the **interest expenditures** for the **public debt** should be considered:

    - **Borrowing** should be **refinanced** if there is no **reduction** in **government debt**. **Budget surpluses** or a **sale of assets** is required for **reducing debt** in absolute terms.

    - The present **low market interest rate** level **is limiting long-term additional costs** of debt.

    - **The gap between the interest rate of the public debt** and **economic growth** ("interest-growth-differential") further restricts the scope of action in the budget.

The planned **reduction of the structural budget deficit from 2012 until 2016** is 0.4% of BIP p. a. according to the Austrian Stability Program (April 2012). According to the recommendation of the Council of the European Union (June 2012), Austria should implement the **2012 budget as envisaged** and **reinforce and rigorously implement the budgetary strategy for the year 2013 and beyond** in order to ensure that the average annual structural budget adjustment, which was set on the backdrop of the ED Procedure (average structural budget adjustment 0.75% des GDP p. a. from 2011 to 2013) is maintained.