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AUSTRIA

Selected Issues

Prepared by Erik Lundback, Daniel Kanda (both EUR), and Alexander Tieman (MCM)

Approved by the European Department

April 2, 2007

Contents Page

I. A Medium-Term Budgetary Framework—What Can Austria Learn From Other Countries? ... 3
A. Introduction ... 3
B. The Proposed Austrian Medium-Term Budgetary Framework ... 3
C. Medium-Term Budgetary Frameworks in Other Countries ... 5
D. Conclusions ... 10
References ... 13

II. Long-Run Fiscal Challenges in Austria ... 15
A. Background ... 15
B. Impact of Aging on Pension Expenditures ... 15
C. Impact of Aging on Health and Long-Term Care Expenditures ... 23
D. Education and Unemployment Benefits ... 25
E. Overall Impact of Aging on the Fiscal Position ... 25
F. Concluding Remarks ... 26
Appendix. Decomposition of Pension Expenditures ... 27
Bibliography ... 28

III. Cross-Border Banking Issues for the Austrian Banks and Their Supervisors ... 30
A. Introduction ... 30
B. The Austrian Banking Sector ... 30
C. Austrian Banks in CESE ... 33
D. Challenges for the Banks Going Forward ... 35
E. Implications for Supervision ... 38
F. Concluding Remarks ... 41
References ... 42

Tables

III. 1. Main Components of the Financial Sector....31
2. Size of the Banking Sector, December 2006....32
3. Austria and Other European Countries: Selected Banking Sector Performance Indicators, 1992–2005....33
4. Majority-Owned Subsidiaries of Austrian Banks in CESE, 2005....35

Figures

I. 1. Selected Industrialized Countries' General Government Balance....8
2. General Government Balances and GDP Growth Rates....8
II. 1. Austria and EU-15: Pension Expenditure, 2000–04....15
2. Decomposition of Pension Expenditure Projections, 2004–50....18
3. Eurostat Assumptions for the Population Projection Variants, 2004–50....20
4. Old-Age Dependency Ratio Under Various Population Scenarios....19
5. Pension Expenditure Under Different Population Scenarios....21
6. Pension Expenditures with Higher Eligibility Rate and Benefits Growth and Lower Employment Rates....22
7. Pension Expenditures Under Best and Worst Case Scenarios....23
8. OECD Public Health and Long-Term Care Expenditure Projections....23
9. ECFIN Public Health Expenditure Projections Under Different Scenarios....24
10. Public Debt–Best and Worst Case Scenarios....26
III. 1. Bank Branch Density....32
2. Domestic Market Shares of Austrian-Owned Subsidiaries in CESE....34
3. Consolidated Foreign Exposure to CESE, 2005....34
4. Net Interest Margins....36

Boxes

III. 1. The EU Framework for Cross-Border Supervision, Regulation, and Crisis Management....40

I. A MEDIUM-TERM BUDGETARY FRAMEWORK—WHAT CAN AUSTRIA LEARN FROM OTHER COUNTRIES? [1]

A. Introduction

1. **Austria is part of a trend among many countries to consider some form of medium-term budgetary framework (MTBF).** An MTBF is broadly defined here as a framework that regulates policymakers when formulating and implementing medium-term/ multiyear fiscal policies. It may or may not include a fiscal policy rule that sets numerical restrictions on key fiscal policy objectives. The purpose is to promote fiscal discipline and address fiscal vulnerabilities through increased transparency, stronger accountability, and a more pronounced medium-term perspective. Many developed countries, including in the EU (e.g., the Netherlands and Sweden), now have explicit MTBFs in place. There are also countries (e.g., Denmark), whose governments, while not formally having adopted such a budgeting framework, are setting and formulating fiscal policies along similar lines.

2. **This section sets out to describe the proposed framework in Austria and to assess it in the light of the experience of other countries.** The general conclusion, in this section and other literature, is that the track records are mixed, but that, on balance, the experiences with MTBFs have been favorable. However, it is not easy to draw general conclusions about the effectiveness of MTBFs, as the exact designs differ across countries and the effects on fiscal policy outcomes are difficult to isolate. Therefore, a key angle of the paper is to attempt to identify particular characteristics of other countries' frameworks that have been effective and that can be applied to Austria. Equally important is to highlight aspects that have caused or could cause problems, as well as possible trade-offs that could arise when setting up a framework.

B. The Proposed Austrian Medium-Term Budgetary Framework

3. **There seems to be broad political support for an Austrian MTBF.** There are various reasons for this: First, the MTBF could promote medium-term-oriented fiscal policies with an emphasis on the expenditure side, and on disciplined execution to avoid persistent fiscal deficits and debt buildup. Second, the MTBF could help achieve the goal of budget balance over the cycle for the general government. This objective was clearly stated in the January 2007 Government Program. Third, the Austrian MTBF, with a focus on expenditures, would be useful as there is limited room for fiscal consolidation through higher taxes and there seems to be broad agreement that the scope for tax increases is restricted by increased international economic integration.

4. **The current plans to reform the Austrian budgeting framework focus on the federal government** (see figure below). General government public finances are already restricted by Austria's commitments through the Stability and Growth Pact as a euro area

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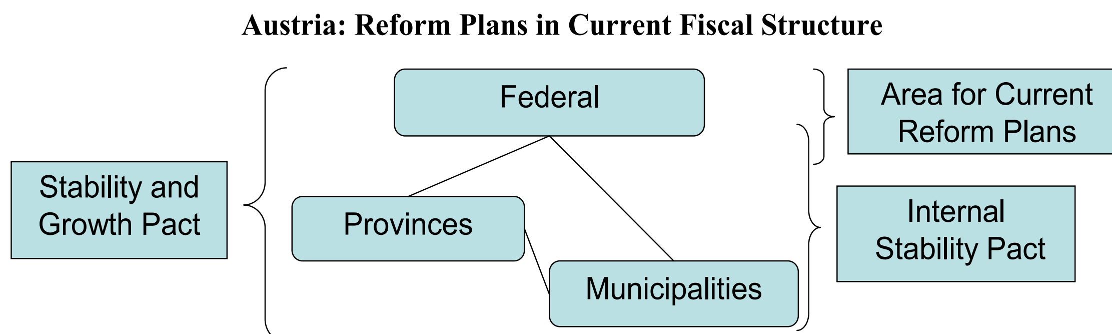
[1] Prepared by Erik Lundback. This section provides information and analysis in support of paragraphs 22 and 33 of the Austria Staff Report.

country. The finances of lower-level governments and their fiscal relationships with the federal level are regulated by the Internal Stability Pact and the Revenue Sharing Act.[2]

Austria: Reform Plans in Current Fiscal Structure



5. **A proposal for an MTBF prepared by the Ministry of Finance has been sent to Parliament, but has not been discussed.** Adopting an MTBF would require a constitutional amendment, which, in turn, requires support by two-thirds of the Parliament. The basic proposed outline is as follows:[3]

- The constitution would declare sustainable government finances and macroeconomic equilibrium as general objectives.

- The MTBF would apply to the expenditure side, cover four years, and be rolled forward by one year every spring. The expenditure ceilings for individual ministries would be binding the first year, while the ceilings for the last three years would be indicative.

- There would be two types of expenditure ceilings: (i) cyclically sensitive expenditures would be set by parameters and updated based on new economic data in the fall before each year; and (ii) other expenditures would be fixed in nominal terms.

- To set strategic expenditure priorities, expenditures would be broken down by individual policy areas and subsequently allocated among ministries.

6. **There seems to be no explicit provision in the proposal for a balanced budget over the cycle.** The Stability and Growth Pact, which Austria is subject to as a member of the EMU, does stipulate limits and reference values for overall budget balances and public

[2] See also Diebalek, Köhler-Töglhofern, and Prammer (2005); Schratzenstaller (2005); and Fuentes, Wurzel, and Wörgötter (2006).

[3] Austrian Federal Ministry of Finance (2005).

debt levels.[4] It does not appear that the MTBF is intended to include a requirement to conduct and incorporate a long-term fiscal sustainability analysis in order to ensure consistency between medium-term policies and long-term outlooks. Finally, there is no mentioning of an explicit error-correction mechanism that would apply in case actual budget outcomes are significantly different from the budgets. However, deviations are to be corrected in the annual updates of the framework.

7. **Further budgeting reform would be implemented together with the MTBF.** This will be more time-consuming, taking at least four–five years to fully implement. Four major "principles" of budgeting would be implemented:

(i) *Performance budgeting*, implying a shift away from the prevailing input-orientated budgeting to the more direct linking of expenditures to objectives.

(ii) *Transparency*, encompassing the current principles of budget transparency, the exhaustiveness of the budget, unequivocal assignments of responsibility in the budgetary process, and the provision of timely information on the execution of the budget.

(iii) *Efficiency*, applying to all forms of government activity with a focus on the spending of budgetary resources.

(iv) *Accuracy in representing the financial situation of the federal government*, implying sophisticated systems of budgeting, accounting, and reporting.

C. Medium-Term Budgetary Frameworks in Other Counties

8. **Formal MTBFs that regulate policymakers when formulating and implementing multiyear fiscal policies have been introduced in other countries to support fiscal discipline and address fiscal vulnerabilities.** Discretionary fiscal policies can result in pro-cyclicality and deficit bias, driven by political economy factors and weak fiscal management.[5] The design differs substantially among countries, but generally MTBFs address these vulnerabilities in two ways: through (i) fiscal responsibility principles guiding policy formulation, objectives, reporting, and analysis; and (ii) numerical fiscal policy rules for key variables, such as total expenditures and the overall medium-term budget balance. Most, if not all, MTBFs include elements of both, and fiscal policy rules are often a key reflection of the principles of fiscal responsibility.

Why have countries introduced MTBFs?

9. **MTBFs and fiscal policy rules have generally been introduced when the need to discipline fiscal policy was strong.** The most common trigger has been a period of persistent fiscal deficits and debt buildup. Often, the deficits were caused by an underlying

[4] See, e.g., Annett, Decressin, and Deppler (2005) and Morris, Ongena, and Schuknecht (2006).

[5] See, e.g., Jaeger (2001).

trend of expenditure growth, and an important motivation for introducing an MTBF have been to better control public expenditures (e.g., in New Zealand and the Netherlands). An economic crisis can be a trigger, making it politically much easier to adopt a framework as the potential benefits of conducting strong fiscal policies become apparent. Long-term fiscal sustainability considerations and a desire to make room for tax cuts through disciplined expenditures are other reasons for introducing MTBFs.

The general experience with MTBFs

10. **The experience with these types of frameworks is still limited as most of them have been introduced only quite recently.** In particular, relatively few frameworks have been tested across business cycles. Five industrial countries with some formal MTBF in place before 2000 have been studied more closely for this section: Australia; New Zealand; the Netherlands; Sweden; and the United Kingdom. In addition, two more countries, in which formal frameworks are not in place, but the governments still have been setting and formulating fiscal policies along the lines of an MTBF, have been analyzed as well: Canada; and Denmark.

11. **The fiscal developments in Australia and New Zealand suggest that their frameworks, with an emphasis on transparency and public clarity, have been effective**. In 1994, New Zealand adopted its the Fiscal Responsibility Act, which legislated budgetary principles of transparency, and mandatory short, medium, and long term plans. The act has a clear emphasis on budgetary principles rather than specific numerical targets. In 1998, Australia adopted the Budget Honesty Act, which has a similar emphasis on legislated budgetary principles.[6] Since these frameworks were introduced, both countries have been running fiscal surpluses, and debt levels have also been reduced.

12. **The relatively strong fiscal performance of the Netherlands and Sweden, in particular in the second half of the 1990s, explains why these two rules-based expenditure frameworks have received much attention.** The Netherlands has had its rules based medium-term expenditure framework in place since 1994, and Sweden adopted its framework in 1997. Both frameworks were initially seen as successful, with narrowing budget deficits, eventually turning into surpluses. In the early 2000s, both countries ran into problems. The Netherlands' fiscal position deteriorated and recorded substantial deficits for a few years, which prompted a reform of its fiscal framework to treat revenue windfalls more restrictively. Sweden managed to perform relatively well, with only small deficits in 2002 and 2003; however it is still lagging in terms of reaching the target of a 2 percent surplus on average.[7]

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[6] Australia (1998). See also Simes (2003) for an overview and analysis of the framework. For New Zealand, see New Zealand Treasury (1996), Janssen (2001), and International Monetary Fund (2005).

[7] Descriptions and analyses of the framework in the Netherlands can be found in Blöndal and Kromann-Kristensen (2002), Tijsseling and van Uden (2004), and Hofman (2005). See Annett (2003) and Balassone (2005) for discussions of the Swedish framework.

13. **The framework in the United Kingdom is generally regarded as having been successful in containing discretion and allowing automatic stabilizers to work**.[8] In 1998, the United Kingdom introduced the "golden rule" and the "sustainable investment rule" as the cornerstones of its fiscal policies.[9] The government is allowed to borrow only for investments, and the average current position should be balanced or in surplus over the cycle. The formulation of the Golden rule "over the cycle" gives rise to two potential complications: the uncertainty surrounding the dating of the cycle and a risk of pro-cyclicality in the event of asymmetric cycles.[10] Overall, the framework is considered to have worked well.

14. **Canada and Denmark both have strong fiscal policy track records that have been guided by clearly explained medium-term-oriented policies**. Neither Canada nor Denmark has formal frameworks regulating how medium-term fiscal policies should be formulated or reported. However, in practice both countries have had important elements of fiscal responsibility principles, and medium-term-oriented fiscal policies and objectives have been in place since the 1990s.[11] Both countries now stand out as having had prolonged periods of strong fiscal performance, with fiscal surpluses and falling debt. Canada has also been able to reduce its expenditure level faster than many other industrial countries.

15. **Overall, the fiscal performance of countries with an MTBF has been relatively strong (Figure 1).** Moreover, among countries with similarly strong track records, four countries (Belgium, Finland, Spain, and Switzerland) now have MTBFs in place. High economic growth could potentially also explain the better fiscal balances recorded for these countries. However, comparing the average fiscal balances against the average growth rates during the period 1997–2006 suggests that most countries with an MTBF have had stronger fiscal balances than could have been expected given GDP growth (Figure 2).

Key aspects from the experience of other countries

Transparency, public clarity, and accountability

16. **Transparency and public clarity are key.** Australia and New Zealand have two of the most successful MTBFs, which have helped promote spending control and sound fiscal policies in general. In both these frameworks, the emphasis is on transparency, public clarity, and legislated principles of fiscal management, as opposed to specific numerical targets. Policy objectives have to be clearly defined and motivated, and put in the context of strategies for the short, medium, and long term, prompting the government to thoroughly address a broad range of crucial and sometimes difficult fiscal policy issues. In such a setting, where fiscal policy objectives and strategies are clearly defined, significant

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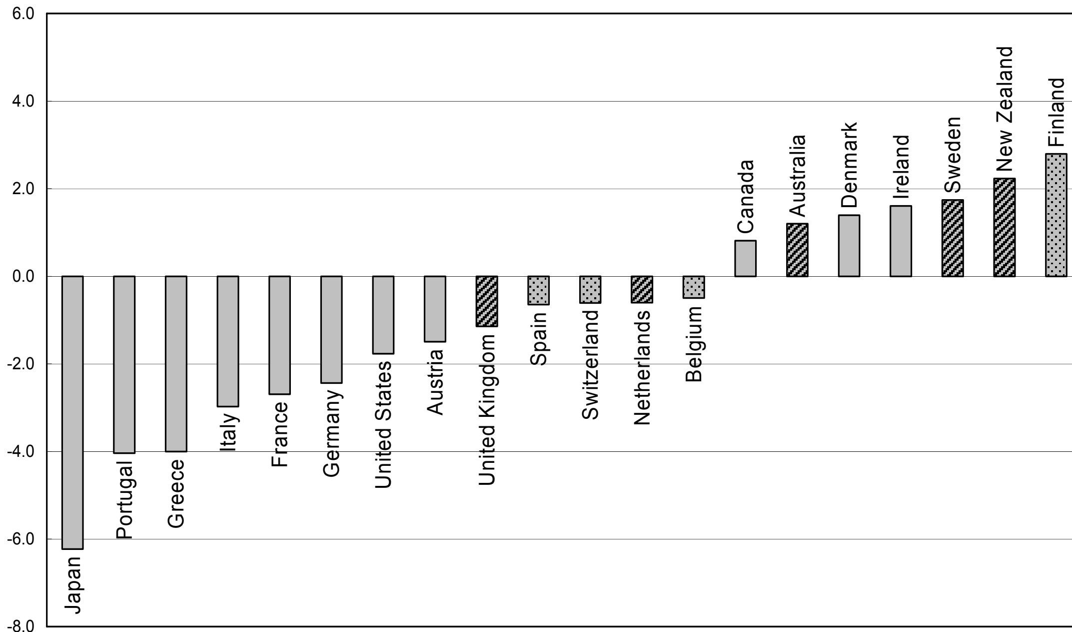
[8] See, e.g., International Monetary Fund (2007).

[9] See Koeva (2005) for a description of the rule and an analysis of the safety margins.

[10] See Honjo (2007).

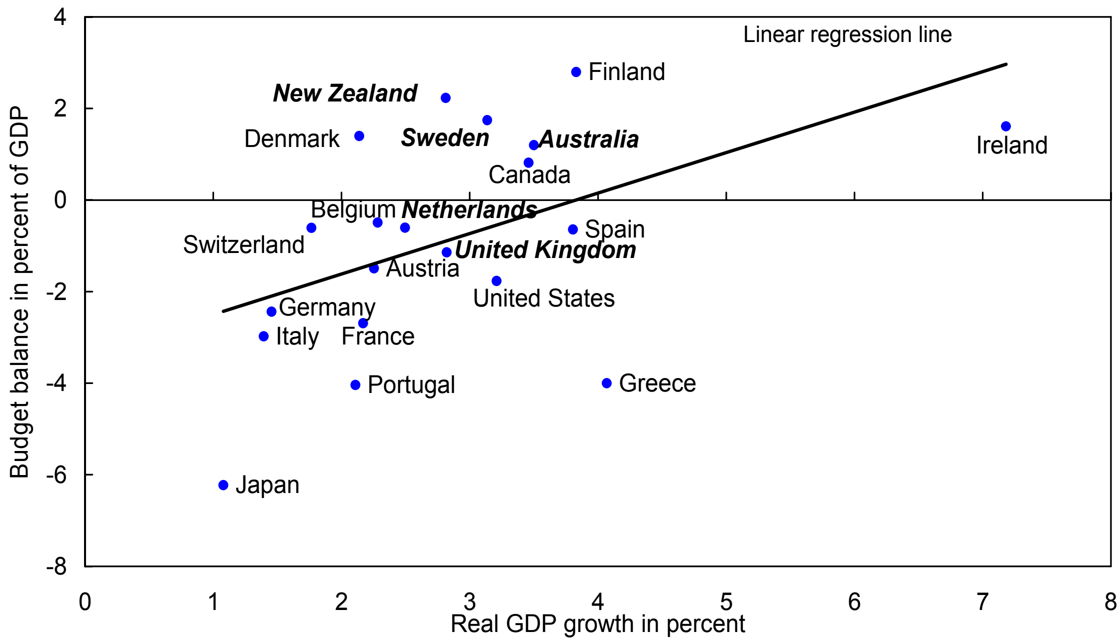
[11] See OECD (2004 and 2006) for a description and analysis of the framework in Canada; for Denmark, see Eskesen (2002).

Figure 1. Selected Industrialized Countries' General Government Balance 1/
(Percent of GDP, 10-year Average,1997-2006)



Source: IMF, World Economic Outlook.
1/ Striped bars indicate countries with an MTBF before 2000, as discussed in this chapter. Dotted bars indicate countries which adopted an MTBF more recently.

Figure 2. General Government Balances and GDP Growth Rates 1/
(10-year Averages)



Source: IMF, World Economic Outlook.
1/ Bold italics indicate countries with an MTBF before 2000, as discussed in this chapter.

deviations will be apparent and the reputation cost will be high, which is likely to be an important incentive for policymakers to adhere to the framework.

17. **Accountability will be strengthened by clearly stating fiscal policy objectives and formulating them within government terms.**[12] Some fiscal policy objectives and commitments have to cross term limits, but, clearly, a new government will feel less obliged to follow fiscal policy plans adopted by a previous government unless these enjoyed very broad political support. A focus on government terms is also consistent with an MTBF as a basis for concrete policy negotiations and coalition agreements, as for example in the Netherlands and Finland.[13]

Building credibility

18. **Establishing early on a strong track record and broad political support will build credibility.** It will show commitment, demonstrate that the MTBF works, and increase the political cost for deviations in the future. The political damage for a government to let fiscal policy slip significantly is arguably higher in countries with good track records, such as Australia and New Zealand, than in countries with a weak policy record. Another example is the Netherlands, where the initial success appears to have helped establish the MTBF as a given in the minds of Dutch voters and economic policymakers.[14]

Broad-Based Fiscal Reform

19. **For MTBFs to be successful they need to be supported by reform of budget management and budgetary institutions in general.** The experience of the Netherlands shows the importance of broad-based budgetary reform, and the government is in the process of gradually implementing performance based budgeting. Sweden has also reformed its fiscal management principles, which arguably have been instrumental in the relative success of its expenditure rules-based fiscal framework in an environment of a one-party minority government.[15] In New Zealand, the Fiscal Responsibility Act was introduced to formalize a successful reform of fiscal management that had already improved the fiscal situation.

Long-term perspective

20. **Long-term analyses as an integral part of short- and medium-term fiscal policy can strengthen an MTBF.** Placing fiscal policy goals and rules in a long-term perspective to ensure fiscal sustainability may shore up public support and thereby credibility. In addition, if fiscal plans and rules are not firmly based on long-term analyses, there is a risk that long-term pressures will lead to fiscal difficulties, even if plans and rules are adhered to. In both Sweden and Finland, medium-term fiscal policies are based on long-term analyses, which

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[12] This is the case in, e.g., Australia, Finland, the Netherlands, and New Zealand.

[13] For Finland, see Finland Ministry of Finance (2005).

[14] See, e.g., Hofman (2005)

[15] See Annett (2003) for a brief discussion of this point in the context of the Swedish MTBF.

contribute to increase public understanding of fiscal policies framed by fiscal policy rules. Another example is New Zealand's Fiscal Responsibility Act under which continuously updated 10-year plans are mandatory and, since 2004, long-term fiscal analyses are required every fourth year.

Lower Level Governments

21. **Regional and local governments present a challenge.** The degree and type of challenge differ among countries, and it is difficult to generalize, but clearly, when local and regional governments are relatively large, politically powerful, and/or independent, they will play an important role. This presents a number of potential interdependent problems for an MTBF. First, local and regional governments typically want a certain degree of autonomy and may therefore be reluctant to participate in and agree on an MTBF. Second, when implementing the MTBF, there may be difficulties in reaching agreements between different levels of government. Third, transfers to and from local and regional governments may distort the incentive structure. More generally, the central government may not have sufficient fiscal control of local governments, which may result in some loss of fiscal discipline and of adherence to MTBFs and fiscal policy rules.

Fiscal rules

22. **Experiences with fiscal policy rules have been mixed, but multiyear expenditure rules appear to have helped disciplining expenditures in some cases.** Of particular interest to Austria are the Netherlands and Sweden, where medium-term expenditure frameworks were introduced relatively early. Although both countries have had difficulties in meeting some of their fiscal balance targets, it seems the rigor of the expenditure rules in place has effectively restrained fiscal expenditures.[16] Moreover, Sweden has been running fiscal surpluses in recent years, which separates it from its past, and from many other EU countries. It also appears that the Netherlands' expenditure framework was important for the significant fiscal consolidation in recent years, as well as in periods when the underlying economy was relatively weak. Still, it must be emphasized that rules alone do not create sound fiscal policies; they must be part of a broad-based effort to conduct clearly explained, medium-term-oriented, efficiently managed fiscal policies. Fiscal policy rules may also have pro-cyclical tendencies, allowing policies to be too accommodative during economic upturns.[17]

D. Conclusions

23. **MTBFs have proved to be effective in other countries, and the plan to introduce such a framework in Austria is strongly welcomed.** It would be a national framework complementing and deepening the commitments under the SGP. While an MTBF cannot by itself provide solutions, it can be a useful vehicle for addressing fiscal challenges facing Austria, thus contributing to macroeconomic stability and predictability, and to fiscal

[16] See Balassone (2005) for Sweden and Hofman (2005) for the Netherlands.

[17] See Annett (2003) for the case of Sweden, and Zhou (2004) for the Netherlands.

sustainability. A well-designed framework could facilitate the formulation, implementation, and communication of fiscal policies, drawing immediate attention to basic policy choices in the medium to long term. As in other countries, an MTBF could be a useful basis for policy discussions and agreements in Austria, which has a tradition of coalition governments.[18]

24. **The basic outline of the proposed framework, including multiyear expenditure ceilings, seems appropriate.** There appears to be broad agreement that controlling expenditure must be the focus. There is limited room for tax hikes, as taxes are not low, and past periods of significant deficits and debt buildup have been associated with high levels of public spending. Formal multiyear expenditure ceilings therefore appear to be attractive instruments of budgetary control for Austria. In this context, a special emphasis on the reporting and analysis of policies during a government term may be worth considering.

25. **Austria should make transparency and public clarity key features of its MTBF.** Based on experience elsewhere, legislated principles of transparency and public clarity seem to have been overall quite effective. Clearly, legislation and regulations should be comprehensive in this regard; however, this is also an area where policymakers could and should be proactive and ambitious, as this has proved to be effective in fostering responsible fiscal policies in other countries. The annual Stability Program and other work done in the context of Austria's participation in the SGP provide a good basis to build upon.

26. **The planned introduction of an MTBF as part of a broader reform agenda to improve fiscal management will increase the likelihood of success.** Based on the experience of other countries, this will help the successful implementation of an MTBF. Therefore, Austria should make an effort to implement the various aspects of the broad fiscal management reform agenda in parallel.

27. **Long-term considerations should be an integral part of the framework.** Austria, like most other advanced countries, faces significant demographic challenges in the medium to long term.[19] Therefore, long-term goals and restrictions should be mapped to concrete medium-term targets that in the end define the envelope for current fiscal policies and anchor the expenditure ceilings. This long-term perspective would help maintain satisfactory, and sustainable fiscal policies, and avoid future fiscal tensions.

28. **It will be essential to analyze thoroughly and deal with the implications for subnational governments in designing and implementing an MTBF.** Austria is faced with an element of pro-cyclicality at the lower levels of government as the annual balance targets within the internal stability pact do not vary with the cyclical position of the economy.[20] More generally, fiscal policy set in a medium-term perspective would typically focus on the

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[18] von Hagen, Staruch, and Hallerberg (2004) find that explicit rules are most effective where governments typically are multiparty coalitions.

[19] See also section II of this paper.

[20] The potential problem of pro-cyclicality has also been pointed out by Schratzenstaller (2005), and in particular by Diebalek, Köhler-Töglhofern, and Prammer (2005).

fiscal budget balance over a business cycle, while the internal stability pact sets specific targets for each year. Also, the pact does not specify in detail how the subnational governments should reach their budget balance targets.

29. **The intention to include mandatory buffers in the budgetary projections is welcome and could be complemented by a mechanism for dealing with unexpected windfalls.** Some of these elements are in place in other countries and have been useful. However, it should be noted that buffers can be used up quickly and push problems forward. It would also be advisable to have a system in place to prevent unexpected, possibly temporary, savings or revenues from being used for additional spending or tax cuts, as this could result in a structural fiscal loosening.

30. **Political will is essential for the MTBF's credibility and successful implementation.** Reputation and accountability will ultimately be the main enforcement mechanism of the framework. Consequently, broad-based political support should be secured and, once Austria has adopted an MTBF, every effort should be made to quickly establish a good track record.

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II. Long-Run Fiscal Challenges in Austria[21]

A. Background

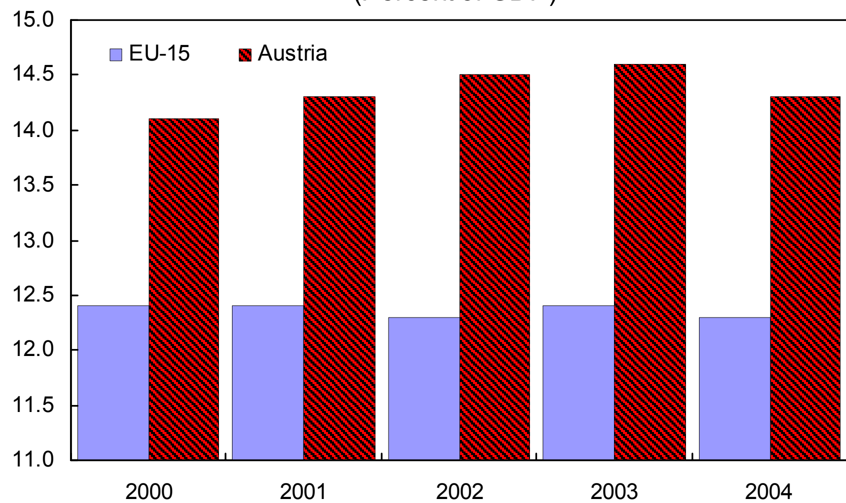
31. **This chapter examines the long-run fiscal challenges arising from demographic change**. Like many industrial countries, Austria faces an aging problem, caused by a reduction of total fertility rates below the replacement rate, and increased life expectancy. Thus, the old-age dependency ratio is expected to double by 2050, and aging pressures are likely to intensify after 2010.

32. **Aging will put upward pressure on fiscal spending on pensions, health, and long-term old-age care costs, as the number of older people increases**. This would, however, be partially offset by a reduction in fiscal expenditure on education and unemployment benefits as the population of younger school- and working-age persons declines. The chapter explores these costs, and their implications for fiscal sustainability.

B. Impact of Aging on Pension Expenditures

33. **Austria has traditionally had relatively generous public pension schemes, with virtually universal coverage**. These were generally based on occupation, and there were separate schemes for the self-employed, farmers, employees, federal civil servants, and civil servants at the provincial and municipality levels. These schemes were based on the pay-as-you-go (PAYG) system. Replacement rates were relatively high, and financing shortfalls for these schemes were covered by fiscal transfers. As a result, pension spending in Austria has been among the highest in the EU15 (Figure 1), and other (occupational and individual) pension pillars are relatively underdeveloped.

Figure 1. Austria and EU-15: Pension Expenditure, 2000-04
(Percent of GDP)



Source: Eurostat.

34. **Earlier projections pointed to a significant increase in pension expenditures as a result of aging**. For example, Eskesen (2002) projected that from 2000 to 2050 public

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[21] Prepared by Daniel Kanda. This section provides background information and analysis in support of paragraphs 20-21, 32-34, and Appendix I of the Austria Staff Report.

pension expenditures could increase by 3 to 6 percentage points of GDP. The Austrian Stability Program for 2001-05 projected an increase of 2.5 percentage points of GDP in pension expenditures between 2000 and 2050.

35. **Since then there have been two major waves of reform, in 2003 and 2005**. The 2003 reforms primarily affected the public pensions for workers and employees—the Allgemeine Sozialversicherungsgesetz (ASVG)—and the federal civil service:

- Regarding the ASVG, the average wage used as the base for calculation of pension benefits was changed from the average of the 15 best years to the average of the 40 best years of wages (with all wages expressed in constant prices). However, this is to be implemented with a long transition—the number of years used in the calculation is increased by one every 12 months, from 2004 onward, so that full implementation will be achieved only by 2028.

- The accrual rate for pension benefits was reduced from 2 percent per annum to 1.78 percent per annum. The maximum pension was set at 80 percent of the average wage, so that a working (and contribution) history of 45 years would be needed to achieve this maximum rate.

- The minimum age for early retirement was increased from 61.5 for men and 56.5 for women to the statutory retirement ages of 65 for men and 60 for women, to be phased in until 2017, thus essentially abolishing early retirement by 2017. During the transition period, when early retirement is still possible, the associated penalty was increased from 3 percent per year of early retirement to 4.2 percent, subject to a 15 percent cap.

- At the same time, the premium for retiring later than the statutory age was also increased from 3 to 4.2 percent per year of late retirement, subject to a 10 percent limit, such that the maximum pension benefit from late retirement would be 90 percent of the average wage.

- Access to early retirement on account of unemployment was eliminated.

- But, reflecting political pressures, a 10 percent limit was placed on reductions of benefits to individual pensioners arising from the reforms.

- For the federal civil service, the period for calculation of the average wage was also changed to 40 years (rather than the final wage), to be phased in by 2028. The annual accrual rate was reduced as well, the retirement age increased to 65 years, penalties for early retirement (from age 61.5 to 65 years) increased from 3 percent to 3.36 percent, and pension contributions increased by 1 percent.

36. **The 2005 reforms harmonized all the pension schemes for persons under 50 years of age on January 1, 2005 (excluding subnational civil servants) into a single system**:

- The new system is a notional defined-benefits system with individual accounts. For a person retiring at the statutory age of 65 years, with at least 40 years of work/contribution history, the pension benefit is calculated as 80 percent of the average income for the best 40 years of wages (at constant prices). Pension benefits are accumulated at an annual rate of 1.78 percent, so that 45 years of contributions are needed to obtain a full pension.

- A retirement corridor of 62-68 years was introduced for persons with at least 37½ years of contribution history. Within this corridor, retirement at an age above the statutory age of 65 years attracts a premium, while retirement below 65 years generates a penalty. In both cases, the premium/penalty is 4.2 percent per year. Where a premium is earned, the maximum benefit is set at 90 percent of the (40 best years) average wage, while for retirement below 65 years the maximum penalty is set at 15 percent of the average wage. For women, further phased increases in the statutory retirement age to 65 would also take place between 2024 and 2033, and they would begin to participate in the "corridor pension" only after their statutory retirement age exceeded 62.

- Given that many have already accumulated benefit rights under the previous pension system, calculation of benefits would involve dual calculations under the old and new systems. Thus, a long transition is envisaged—full implementation of the new system would take place around 2050.

- To ease the pain of the reform, the 10 percent cap on benefit losses arising from the reforms was changed to a phased plan, where the cap was immediately reduced to 5 percent with effect from 2004, and set to increase by 0.25 percentage point per annum back to 10 percent by 2024.

- Contribution rates would be 22.8 percent of wages. However, burden sharing differs according to occupation. For employees, contribution payments are split equally between employee and employer. For the self-employed, contributions would increase from 15 to 17.5 percent of income, while for farmers contribution rates would increase from 14.4 percent to 15 percent, with both increases phased in over 10 years, and the gap in contributions made up by transfers from the federal government budget.

- Pension benefits would be adjusted annually according to consumer price inflation, in contrast to the earlier practice of adjusting benefits in line with wage growth.

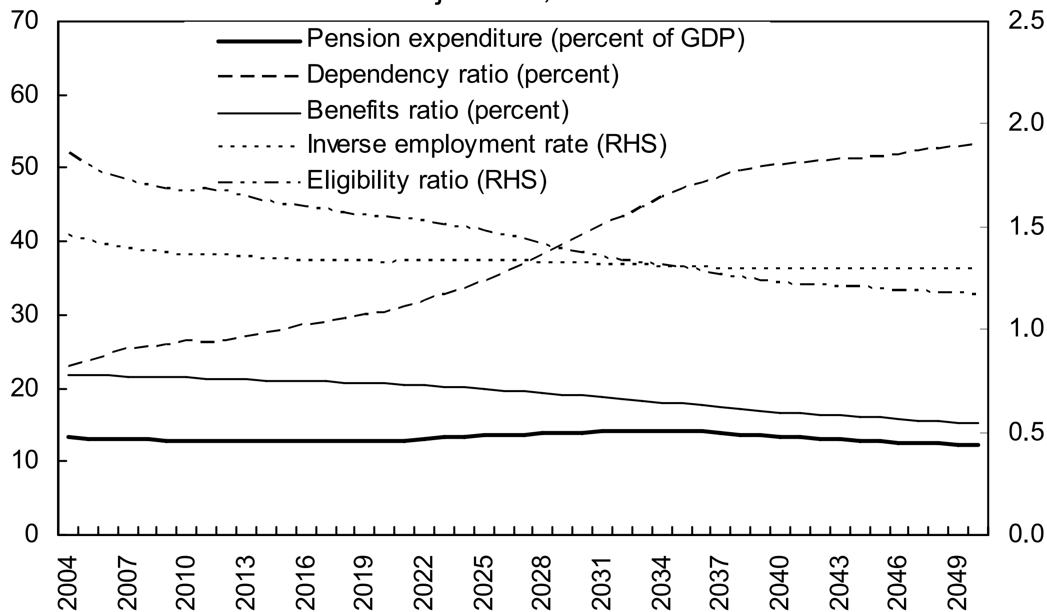
- However, in a step back from the objective of increasing the average retirement age, other avenues for early retirement were introduced. In particular, an early retirement scheme for those doing heavy physical work (with heavy work not well defined) was

introduced. Also, access to disability retirement for unskilled persons aged 57 and older was relaxed.

- There would be three-year reviews of the evolution of pension expenditure.

37. **Following these reforms, the authorities' projections (as reported in the 2006 ECFIN report on aging) estimate that pension pressures would be contained by 2050**. These projections of pension expenditure can be decomposed into the underlying assumptions regarding the evolution of the old-age dependency ratio, benefits ratio, employment rate, and the eligibility rate for pensions (Figure 2).[22] As demonstrated in the

Figure 2. Austria: Decomposition of Pension Expenditure Projections, 2004-50



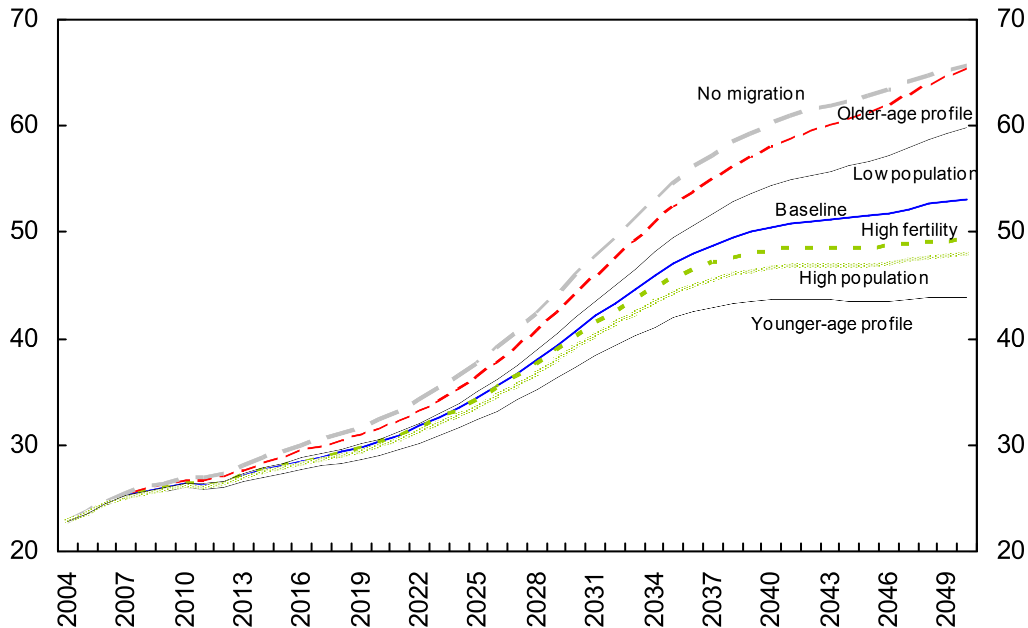
Sources: European Commission DG ECFIN Special Report No 1/2006; and staff estimates.

appendix to this chapter, the product of these four ratios equals the ratio of pension expenditure to GDP. As observed in Figure 2, the projections are based on a rising dependency ratio being offset by declines in eligibility and benefits ratios and an increase in the employment rate. By 2035, the downward pressures more than offset the upward pressures, and pension expenditure as a percentage of GDP falls slightly from then on.

[22] The old-age dependency ratio is the ratio of the old-age population to the working-age population; the inverse employment rate is the ratio of working-age population to employment; the eligibility ratio is the ratio of pensioners to old-age population; and the benefits ratio is the ratio of average pension benefits to economy-wide labor productivity.

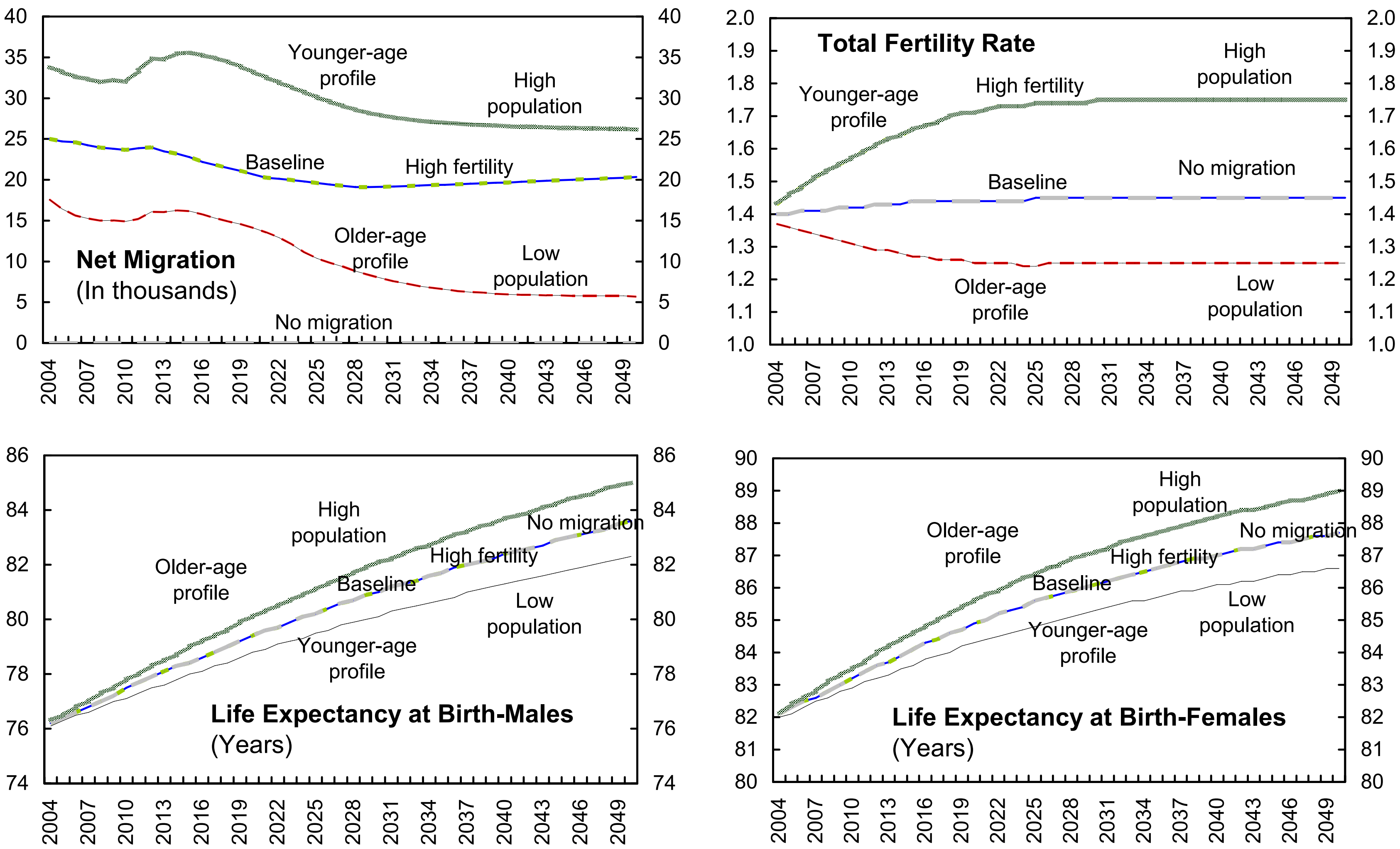
38. **The projections are subject to significant uncertainty margins, given the long projection horizon**. With regard to the old-age dependency ratio, in addition to the baseline population projections (which underlie the authorities' projections) Eurostat provides six other projections, with selected permutations of assumptions on net migration, the total fertility rate, and male and female life expectancy (Figure 3; next page). These are the "no migration" scenario, with zero net immigration; the "older age profile" with low net migration, low fertility, and high life expectancy; the "younger age profile" with high net migration, high fertility, and lower life expectancy; "high fertility" with high fertility and baseline net immigration and life expectancy; "high population" with high net migration, high fertility, and high life expectancy; and "low population" with low net migration, fertility, and life expectancy. These projections thus provide estimates of the likely range of variation in the dependency ratio up to 2050. For Austria, these suggest that the dependency ratio could vary between 44 percent and 66 percent by 2050 (Figure 4). With the other parameters—eligibility, employment and benefits ratios—assumed to be unchanged, this implies that pension expenditure in 2050 could vary between 10 percent of GDP and 15 percent of GDP, depending on the evolution of the population (Figure 5).

Figure 4. Austria: Old-Age Dependency Ratio Under Various Population Scenarios (Percent)



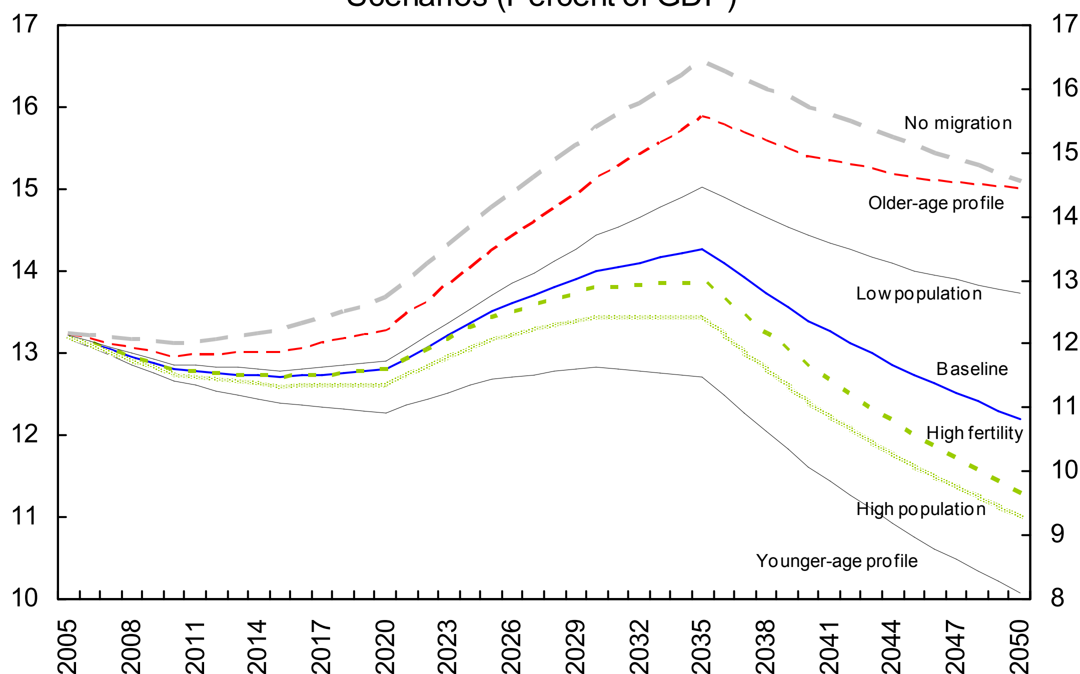
Source: Eurostat.

Figure 3. Austria: Eurostat Assumptions for the Population Projection Variants, 2004-50



Source: Eurostat.

Figure 5. Austria: Pension Expenditure Under Different Population Scenarios (Percent of GDP)



Sources: European Commission DG ECFIN Special Report No 1/2006; and staff estimates.

39. **However, other variables could also evolve in a manner different from the authorities' assumptions**. The assumed substantial decline of the eligibility ratio appears optimistic. The OECD 2005 economic survey reports that inflows into disability pensions are large (over 30,000 persons in 2004, compared with an inflow of about 20,000 for retirement at the statutory age) and have jumped markedly since 2003, apparently because it is being exploited as a loophole to obtain early retirement.[23] Also, as mentioned above, the 2005 reforms introduced other avenues into early retirement, such as the hard-worker initiative.[24] As a result, without further measures to tighten eligibility for early retirement the average retirement age is unlikely to increase significantly, implying a higher eligibility ratio and lower employment of older workers than envisaged. In addition, it is unclear how realistic it is to assume only price indexation of pension benefits over a long horizon.

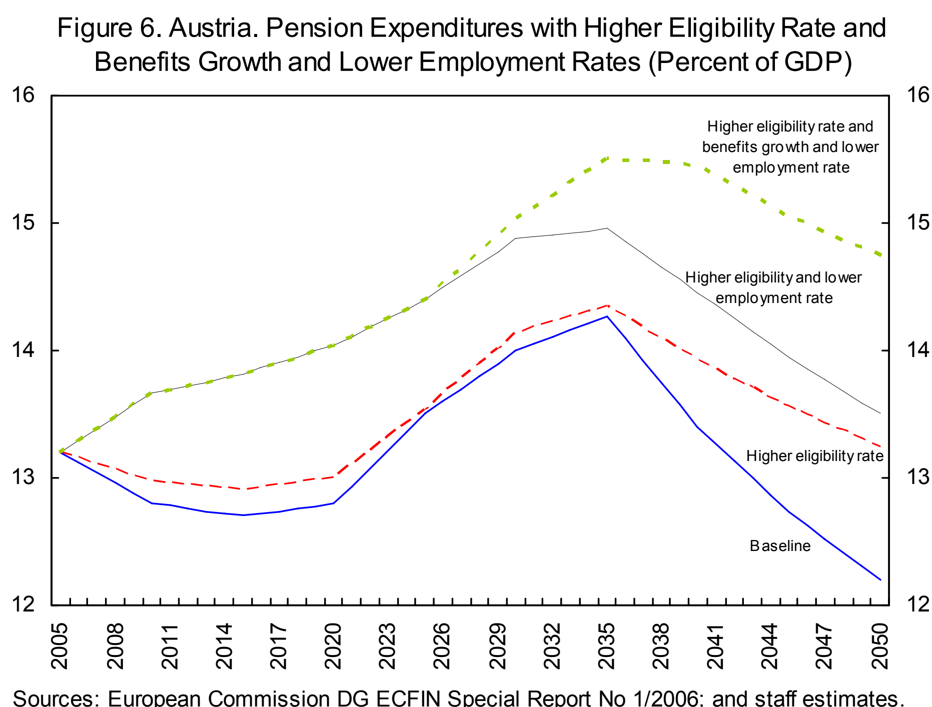
[23] See Figure 2.2 of the report.

[24] This allows for early retirement at a reduced penalty for persons who have done hard or onerous work.

40. **Finally, initiatives contained in the recent government program agreed during the coalition talks raise further concerns**. In particular, it is proposed to significantly cut the penalties for early retirement for those governed by the 2005 pension reforms by cutting the penalty rate within the pension corridor from 4.2 percent to 2.1 percent. Also, persons with long working histories are to be allowed the right to retire early (55 for women and 60 for men) without penalty, until 2010. If offsetting measures are not also implemented, this is likely to substantially increase early retirement and pension expenditures.

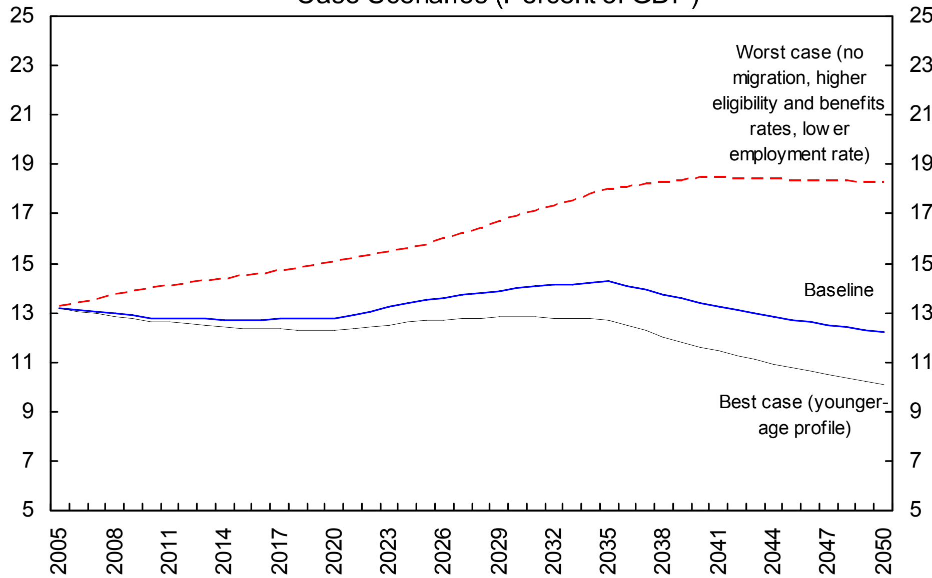
41. **To explore the quantitative implications of these possible developments, alternative projections were prepared**. These assumed the following: (i) the number of pensioners grows at slightly below one-half of the growth rate of the old-age population above 65 years old, implying that the eligibility ratio declines from 1.8 in 2005 to 1.27 in 2050 rather than the authorities' projected 1.17; (ii) the employment rate increases to 76 percent in 2050, rather than the authorities' projection of 78 percent; and (iii) from 2025 onward, average pension benefits grow at a rate ¾ percentage point below average nominal wages. Figure 6 presents the results. As we can see, in this scenario where all three assumptions above are borne out, pension expenditures would rise to almost 15 percent of GDP in 2050.

Figure 6. Austria. Pension Expenditures with Higher Eligibility Rate and Benefits Growth and Lower Employment Rates (Percent of GDP)



Sources: European Commission DG ECFIN Special Report No 1/2006; and staff estimates.

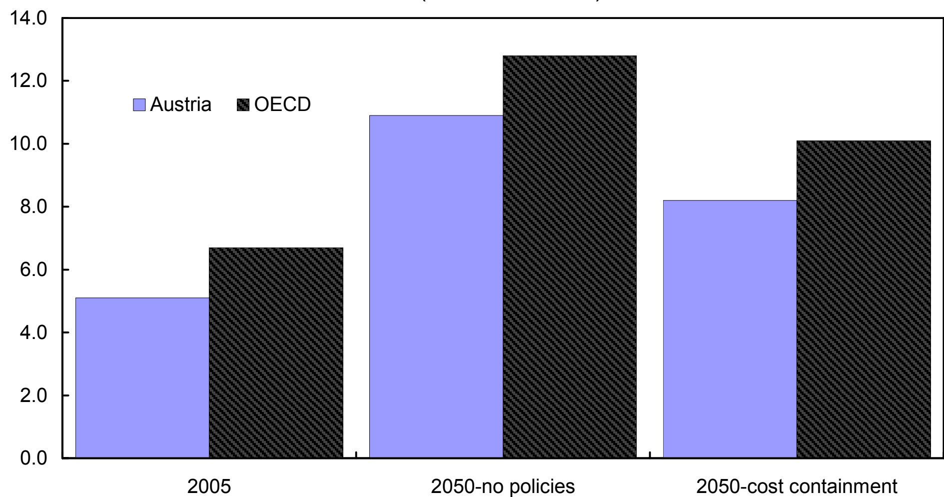
42. **Combining all these variants in the assumptions, we find that in a worst-case scenario, with no migration, higher eligibility and benefits rates, and a lower employment rate, pension expenditures could increase to 18 percent of GDP by 2050**. However this scenario is an extreme case in which the authorities do not react at all even as the fiscal situation deteriorates, and is therefore one which has a low probability of occurring. On the other hand, if the eligibility, benefits, and employment rates evolve as envisaged under the baseline, and in addition the population evolves in line with the younger age profile variant, pension expenditure would decline to 10 percent of GDP (Figure 7).



Sources: European Commission DG ECFIN Special Report No 1/2006; and staff estimates.

C. Impact of Aging on Health and Long-Term Care Expenditures

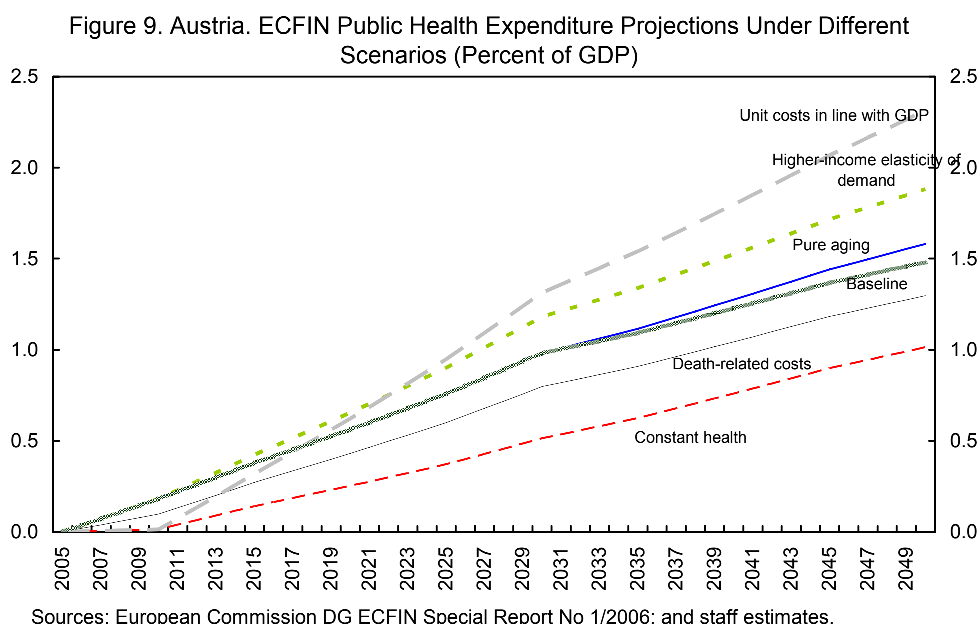
43. **Projecting health and long-term care expenditure is subject to significant uncertainties, related to the health status of the older population as life expectancy increases and the organization of health and care**. Projections prepared by OECD staff point to health and long-term care expenditure increasing by 5.8 percentage points of GDP by 2050, in the absence of cost cutting measures (Figure 8). With (undefined) cost cutting measures, it is anticipated that this increase could be reduced to 3 percent of GDP. The ECFIN aging report considers six scenarios for health expenditure. These are: (i) pure aging, which assumes that all future increases in life expectancy are spent in bad health; (ii) constant health, which assumes that all future increases in life expectancy are spent in good health; (iii) death



Source: OECD Economics Department Working Paper No 477.

related costs, where health care spending on a person is driven by years of remaining life; (iv) higher income elasticity of demand, where the income elasticity of demand is assumed to be higher than unity; (v) unit costs in line with GDP, where costs are assumed to increase at the same rate as GDP per worker; and (vi) a baseline, referred to as the "AWG reference scenario," which incorporates some increase in healthy life expectancy as overall life expectancy increases and an income elasticity of demand exceeding one.[25] On this basis, ECFIN's projections point to increases in a range between 1 and 2¼ percentage points of GDP for health spending by 2050 (Figure 9). Similar projections also point to increases in long-term care expenditure of between ¾ and 1½ percentage points by 2050.

Figure 9. Austria. ECFIN Public Health Expenditure Projections Under Different Scenarios (Percent of GDP)



Sources: European Commission DG ECFIN Special Report No 1/2006; and staff estimates.

44. **Cost-cutting measures could moderate the increase in health care expenditures**. The health care infrastructure in Austria is complex, and there is reportedly room for significant improvements in efficiency in the provision of services, particularly regarding hospitals. A key structural issue is that decision making and financing of similar activities are spread across different levels of government by the constitution, thus leading to duplication and inefficiencies, and complicating reform efforts. Reforms in the health care sector have been limited thus far and have not yet addressed this fundamental structural issue.

45. **Fundamental reforms would require changes to intergovernmental relations**. This would be needed to unify the decision-making process in the health sector, strengthen transparency regarding the use of public funds in the health sector, and eliminate incentives for inefficient provision of health services. However, constitutional reforms intended to

[25] AWG refers to the Aging Working Group of the Economic Policy Committee of the European Commission.

address these and other fiscal-federal issues have stalled so far for lack of the required parliamentary majority. Encouragingly, the new coalition agreement includes proposals for a restart of reform in these areas.

D. Education and Unemployment Benefits

46. **In contrast with the upward pressures on public expenditure from pensions, health and long-term care, aging will lead to downward pressure on education and unemployment benefit spending**. The ECFIN report estimates that by 2050 education spending in Austria would have declined by ¾ percentage point of GDP as the school age population declines, while unemployment benefits will also decline marginally by 0.1 percentage point of GDP.

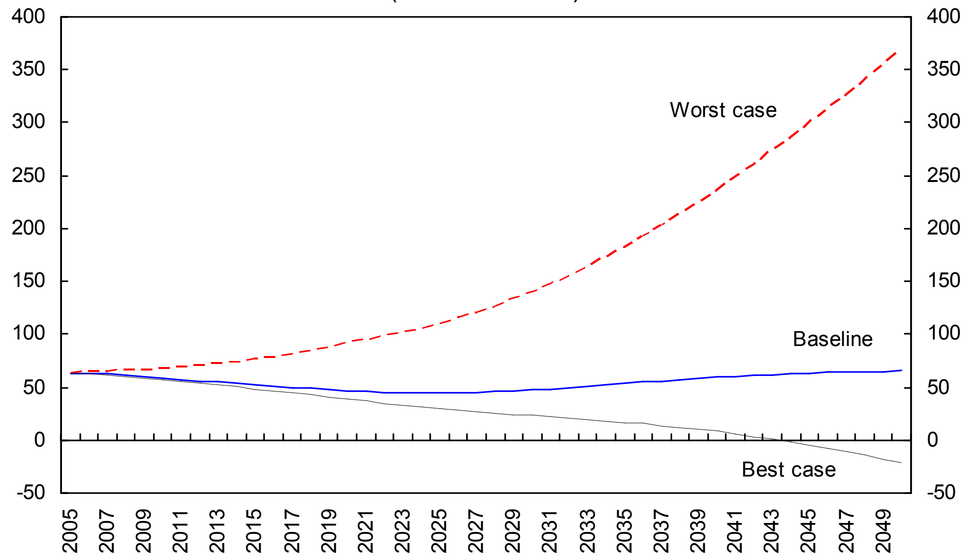
E. Overall Impact of Aging on the Fiscal Position

47. **Projections of the impact of aging on public expenditure are very sensitive to the underlying assumptions.** Overall—combining the baseline projections of the impact of demographic changes on pensions, health, long term care, education, and unemployment benefits—by 2050 the aging process will raise fiscal expenditures by ¾ percentage point of GDP. However, reflecting the wide range of plausible paths for pensions, health, and long term care expenditure, in the best case fiscal expenditures would decline by 2 percentage points of GDP during this period, while in the worst case fiscal expenditures would increase by 9 percentage points of GDP.

48. **As a result, also the projected debt paths vary widely.** The underlying baseline fiscal scenario is a no-policy-change scenario, which assumes that the fiscal stance remains unchanged from 2006 onward, and that revenue and primary expenditure grow at the same rate as nominal GDP. This implies a constant underlying primary surplus of 1½ percent of GDP and an overall underlying deficit that varies between 1 and 1½ percent of GDP over the projection period. Consistent with ECFIN projections, it was assumed that contributions stay broadly stable as a percentage of GDP over the period 2005-50, so that the impact of aging on the fiscal balance is driven by changes in overall expenditures on pensions, health, long-term care, education, and unemployment benefits. The impact of aging was then included as an increase or decrease in primary expenditure, and the overall fiscal balance and public debt, including the impact of aging, was calculated. The average interest rate on public debt was assumed to be 5 percent over the projection period, slightly higher than the average observed for 2005 (4.7 percent), since recent interest rates have been historically low. On this basis, under the baseline aging scenario, public debt initially declines, from 63.3 percent of GDP in 2005 to 44.6 percent of GDP by 2025, but thereafter rises steadily as aging pressures build up, reaching 65.3 percent of GDP by 2050. However, there is a wide uncertainty margin. Under the best case scenario, where aging actually leads to an overall decline in spending, public debt falls below zero in 2044. On the other hand, under the worst-case scenario public debt jumps to more than 300 percent of GDP towards 2050.

49. **With public debt on a rising path, and higher in 2050 than in 2005 under the no-policy-change baseline scenario, this uncertainty implies risks for the sustainability of the fiscal position, given aging (Figure 10)**. Moreover, public debt under the baseline could turn out significantly higher by 2050 if the plans to cut penalties for early retirement are implemented. Thus, further consolidation is needed to ensure sustainability. In this regard, it will be necessary to fully and forcefully implement all the pension reforms, and initiatives that would increase pension spending should be offset by cuts elsewhere. The three-year reviews mandated under the 2005 reforms could be a useful tool for containing pension pressures if vigorously implemented. Reforms in the health sector will also be key in containing fiscal pressures.

Figure 10. Austria: Public Debt - Best and Worst Case Scenarios
(Percent of GDP)



Sources: European Commission DG ECFIN Special Report No 1/2006; and staff estimates.

F. Concluding Remarks

50. **Aging will create long-term challenges in Austria, although the exact size of the challenge is subject to uncertainty**. Nevertheless, it is clear that fiscal consolidation is needed, particularly on the expenditure side, to ensure long-run fiscal sustainability, reduce public debt to a prudent level, and ease the tax burden in order to stimulate private sector activity. An early start to fiscal consolidation is advisable, since it would prevent the need for more wrenching changes later. In this light, recent initiatives to relax access to early retirement are likely to make this task more difficult, as further offsetting measures would be required to ensure sustainability.

Appendix. Decomposition of Pension Expenditures

Pension expenditures can be decomposed as follows:

$$\frac{Pension \quad spending}{GDP} = \frac{Pensioners \quad \times \quad Average \quad benefits}{GDP}$$

$$= \frac{Pensioners}{Employment} \times \frac{Average \quad benefits}{GDP/Employment}$$

$$= \frac{Pensioners}{Employment} \times \frac{Average \quad benefits}{Labor \quad productivity}$$

$$= \underbrace{\left(\frac{Population \geq 65}{15 \leq Population < 65}\right)}_{1} * \underbrace{\left(\frac{15 \leq Population < 65}{Employment}\right)}_{2} * \underbrace{\left(\frac{Pensioners}{Population \geq 65}\right)}_{3} * \underbrace{\left(\frac{Average \quad benefits}{Labor \quad productivity}\right)}_{4}.$$

In the last line above, expression (1) is the old-age dependency ratio, expression (2) is the inverse employment rate, expression (3) is the eligibility ratio, and expression (4) is the benefits ratio. The pension-GDP ratio in any year is the product of these four expressions, and therefore its evolution over time is governed by the evolution of these underlying variables.

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III. Cross-Border Banking Issues for the Austrian Banks and Their Supervisors [26]

A. Introduction

51. **Austrian banks play a major role in many countries in Central, Eastern, and Southeastern Europe (CESE).** Almost all of the large Austrian banking groups have subsidiaries in several countries in CESE. In quite a few cases, these subsidiaries are large compared with the host country's financial systems. Moreover, some of these subsidiaries would probably be judged to be of systemic importance to the financial systems in the host countries. At the same time, the holdings in the CESE are important for the Austrian banks, as they represent a significant part of total assets and provide a major contribution to overall profitability.

52. **This chapter focuses on the challenges associated with the activities of the Austrian banks in CESE.** The paper will briefly discuss the structure of the Austrian banking sector in Section B. It will then discuss the successful expansion of the Austrian banks into CESE in Section C, before focusing on the challenges going forward for the banking system (Section D) and its supervision (Section E). In particular, these challenges stem from (i) the pressure to keep up profitability; (ii) the rapid expansion, with which risk measurement and management have to keep in line; and (iii) the current supervisory, regulatory, and crisis management structure, which has generally not been designed to deal with banking groups that are potentially of systemic importance in several countries.

B. The Austrian Banking Sector

53. **The Austrian financial system is dominated by the banking sector.** [27] At roughly 300 percent of GDP, total banking sector assets are far larger than those of insurance companies and pension funds (Table 1). Mutual fund assets and stock market valuation have increased considerably over the last five years, but also remain small compared with the banking sector. Domestic credit provided by Austrian banks is in line with levels elsewhere in Europe.

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[26] Prepared by Alexander Tieman (MCM). This section provides background information and analysis in support of paragraphs 23-27 and 37-39 of the Austria Staff Report.

[27] For an assessment of the Austrian financial sector conducted in 2003-04 in the context of the Financial Sector Assessment Program (FSAP), see IMF (2004). An FSAP update is tentatively planned for the second half of 2007.

Table 1. Austria: Main Components of the Financial Sector 1/
(At end-2005)

	Billions of Euros	Percent of GDP
Banking sector		
Gross total assets	726	296
Domestic credit 2/	314	128
Insurance sector		
Total financial assets	77	31
Premium income	17	7
Pension funds		
Total financial assets	12	5
Mutual funds		
Total financial assets	157	64
Stock market valuation	106	43
Bonds outstanding	340	139
Memorandum items:		
Euro area domestic credit 2/	11,819	129
Belgium domestic credit 2/	314	105
Germany domestic credit 2/	3,051	136
Sweden domestic credit 2/ 3/	288	121
Switzerland domestic credit 2/ 3/	295	180
United States domestic credit 2/ 3/	9,999	96

Sources: Austrian National Bank; and International Financial Statistics.

1/ Series are not strictly comparable owing to differences in definition and time period.
2/ From IFS banking survey (national residency).
3/ Converted using year-average exchange rates.

54. **The banking sector has a multipillar, tiered structure.** There are seven pillars or categories of banks: joint stock and private banks or commercial banks (*Aktienbanken*), savings banks (*Sparkassen*), rural credit cooperatives (*Raiffeisenbanken*), industrial credit cooperatives (*Volksbanken*), provincial or state mortgage banks (*Landeshypothekenbanken*), building societies or savings and loans associations (*Bausparkassen*), and special purpose banks (*Sonderbanken*) (Table 2). Three of the sectors—the savings banks, Raiffeisen banks, and Volksbanks—have tiered structures, with apex or central institutions at the topmost tier providing centralized services, such as liquidity management and risk assessment, to the other institutions in the sector.

Table 2. Austria: Size of the Banking Sector, December 2006

	Number	Total balance sheet (Euro billions)	Total balance sheet (Percent of total)
All banks	871	798	100.0
Joint stock banks and private banks	48	230	28.8
Savings banks	56	139	17.4
State mortgage banks	10	74	9.3
Rural credit cooperatives	567	197	24.7
Industrial credit cooperatives	69	46	5.7
Building and loan associations	4	21	2.6
Special purpose banks[1]	92	83	10.4
EU Member state credit institutions[2]	25	9	1.1

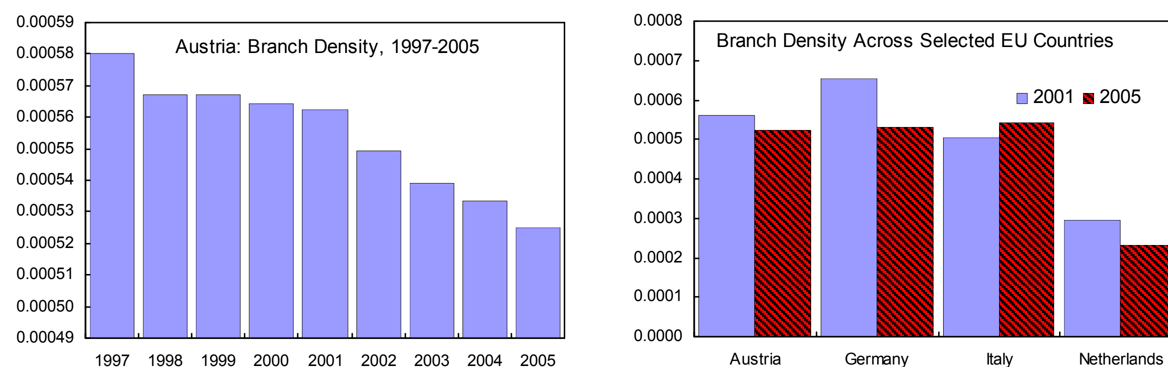
Source: Austrian National Bank.

1/ Includes severance funds, investment companies, and real estate funds.

2/ Foreign bank branches pursuant to Article 9 of Austrian Banking Act.

55. **Despite a period of continued consolidation and restructuring since the early 1990s, bank and branch densities remain among the highest in Europe.** Over the last decade, the number of credit institutions and the number of branches have both decreased, leading to a substantial reduction in branch density. However, density remains on par with densely branched countries like Germany and Italy (Figure 1).

Figure 1. Bank Branch Density



Sources: European Central Bank; and IMF, *IFS*.

Table 3. Austria and Other European Countries: Selected Banking Sector Performance Indicators, 1992-2005

	1992 1/		2001 1/		2005 2/	
	Return on Assets	Cost-to-Income Ratio	Return on Assets	Cost-to-Income Ratio	Return on Assets	Cost-to-Income Ratio
Austria	**0.28**	**64.0**	**0.50**	**67.0**	**0.63**	**63.3**
Belgium	0.15	68.0	0.47	63.0	0.50	65.6
Finland	-2.67	190.0	2.83	38.0	0.80	54.0
France	0.17	67.0	0.58	62.0	0.55	62.0
Germany	0.22	65.0	0.15	70.0	0.28	68.7
Italy	0.37	66.0	0.60	55.0	0.61	60.1
Netherlands	0.41	67.0	0.47	69.0	0.48	67.4
Spain	0.82	60.0	0.76	55.0	0.83	55.5
Sweden 3/	0.21	146.0	0.88	64.0	0.66	55.3
United Kingdom 3/	0.14	66.0	0.75	57.0	0.69	41.8

Sources: Organization for Economic Cooperation and Development (OECD); and European Central Bank (ECB).

1/ OECD data. All banks, except where noted.

2/ ECB data. All banks, consolidated.

3/ For 1992 and 2001, only figures for commercial banks are available.

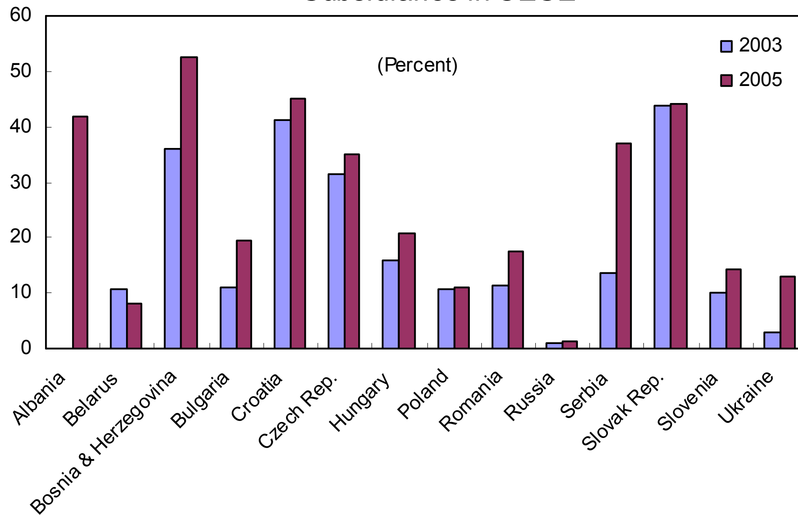
56. **The efficiency of the banking sector has increased over the past few years, but cost-to-income ratios remain high.** Returns on assets have gradually improved over the last 15 years. Since about 5 years ago, this development has gone hand in hand with major improvements in efficiency, as reflected by decreasing cost-to-income ratios (Table 3). Nevertheless, these ratios remain above the average of Austria's European peers, partly reflecting the structure of the banking sector.

C. Austrian Banks in CESE

57. **In the early 1990s, Austrian banks were among the first to enter the Central and Eastern European (CEE) market.** During that period, driven by geographical proximity, historical ties, and a saturated domestic market, most of the larger Austrian banks moved into the region. Generally, expansion started in Hungary and (then) Czechoslovakia. From there on, expansion continued, and currently comprises virtually all CEE markets.

58. **More recently, Austrian banks have entered Southeastern Europe and the CIS.** Between 2003 and 2005, their expansion led to increases in domestic market shares in almost all of CESE, with the increases in Romania and Bosnia and Herzegovina especially large (Figure 2). Some Austrian banks have expanded further east by entering the market in some of the CIS countries, most notably in Russia and Ukraine.

Figure 2. Domestic Market Shares of Austrian-Owned Subsidiaries in CESE

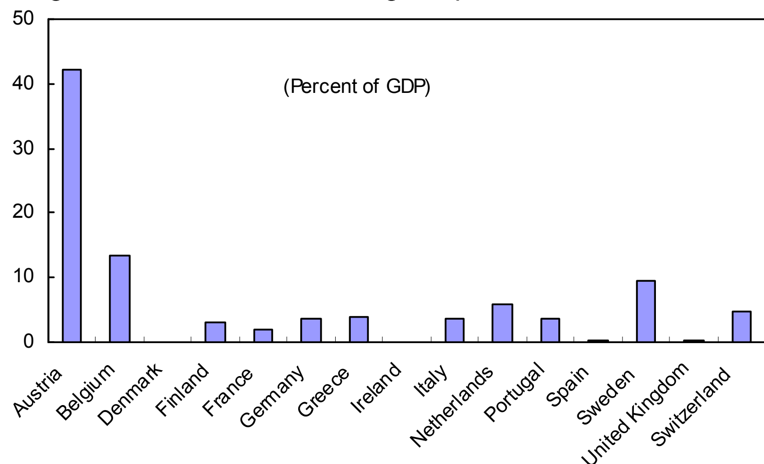


Source: BankScope.

59. **As a consequence, Austrian banks now own subsidiaries that are of key importance in several of the host countries in CESE.** Even though Austrian banks are not large by international standards, their CESE subsidiaries are of considerable size. As the host countries are emerging markets, their financial systems are generally small by international comparison, and their financial markets are still deepening. As a consequence, some of the Austrian-owned subsidiaries are large in relation to the size of the financial systems of the host countries and could be considered of systemic importance.

60. **The Austrian activities in the CESE are also of primary importance for the Austrian banking system, as they constitute a significant share of total assets**. Austrian exposures to the CESE are far larger (relative to GDP) than those of its European peers (Figure 3), even though total consolidated foreign exposures (i.e., to all other countries, relative to GDP) rank only as moderately high compared with those same peers. In 2005, the total assets of the five largest Austrian banks in CESE amounted to some €136 billion, or around 16 percent of total assets. Most subsidiaries are majority owned, with around €130 billion of assets among them (Table 4).

Figure 3. Consolidated Foreign Exposure to CESE, 2005



Source: Bank for International Settlements.

Table 4: Majority-owned Subsidiaries of Austrian Banks in CESE, 2005 1/
(Millions of euros)

	ERSTE	BA-CA	RZB	OeVAG	BAWAG/PSK	Others	TOTAL
Total group assets	152,660	158,879	93,864	54,800	57,898		
Albania			1,657				1,657
Bosnia		481	1,277				1,758
Bulgaria		1,324	1,436				2,760
Croatia	4,123		4,071				8,194
Czech Republic	22,549	7,429	4,003		1,161		35,143
Hungary	5,765	4,532	4,963				15,260
Poland		15,376	2,896				18,271
Romania	9,585	2,652	3,119	524			15,881
Russia			3,979			99	4,078
Serbia	141	200	1,409				1,750
Slovak Republic	6,872	2,014	4,891		916		14,693
Slovenia		1,889	668				2,557
Ukraine			1,233				1,233
Total	49,036	35,898	35,603	524	2,077	99	123,236

Source: Bankscope.
1/ Ownership of 50 percent and above.

61. **Moreover, the activities in CESE contribute significantly to overall profitability.** Domestic profitability of the Austrian banks, although improved in recent years, is low compared to its European counterparts. Overall profitability has been kept up in large part due to the profit contribution of the banks' subsidiaries in CESE. In 2005, activities in that region contributed some 35 percent of pretax profits of all Austrian banks (Austrian National Bank, 2006).

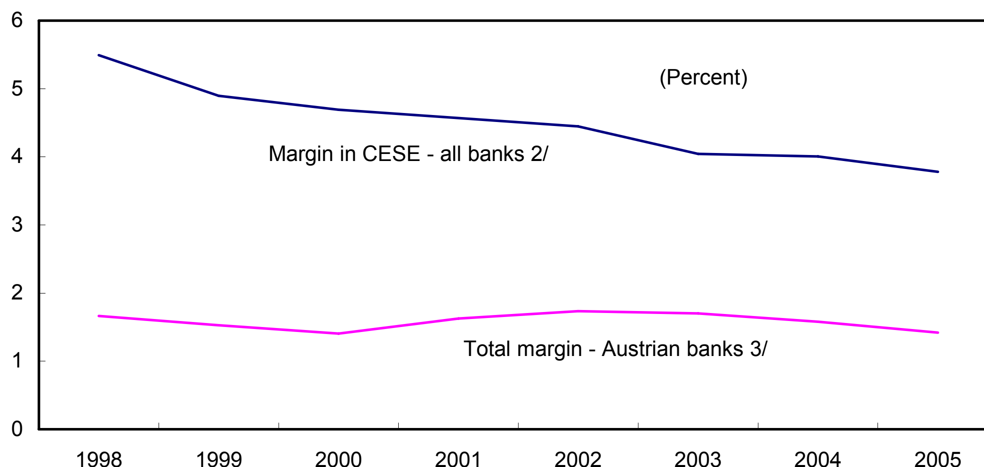
62. **The profitability of the operations in the CESE is driven by the rapid credit growth in these countries.** Credit growth has been high and continues at a rapid pace in most countries in CESE (see, e.g., Cottarelli, Dell'Ariccia, and Vladkova-Hollar, 2003). To a large extent, this reflects financial market development and deepening in these countries. However, the high growth rate of private sector credit has contributed to challenges in the assessment of credit risk (Hilbers and others, 2005, and Schadler and others, 2005), and in some cases, to macroeconomic imbalances in the form of large current account deficits (Lane and Milesi-Ferretti, 2006). At the same time, the strong demand for credit has enabled the banks to lend at relatively large margins.

D. Challenges for the Banks Going Forward

63. **The operating margins in CESE may come under strain in the next few years.** The presumption of continuing large profits builds on expectations of ongoing high economic growth, catch-up in the level of financial intermediation, and wide lending margins. As the financial markets in CESE develop, credit growth may start to slow. Some studies indicates that, indeed, some countries in the region, and in particular in CEE, have come close to their equilibrium level of private credit to GDP, and some risk of overshooting exists (Backé,

Egert, and Zumer, 2006). Moreover, the development of financial markets may affect profits more directly by increasing competition and, hence, narrowing margins. Indeed, banks' interest rate margins in CEE have exhibited a declining trend for some years now (Figure 4). Margins could come under further strain if expectations for economic growth in the region and the concomitant level of financial intermediation turn out to have been too optimistic.

Figure 4. Net Interest Margins 1/



Sources: BankScope; Organization for Economic Cooperation and Development.
1/ Net interest income divided by total assets.
2/ All banks in country, simple average over countries.
3/ All banks, consolidated basis.

64. **Operations in CESE entail a number of other risks as well** (Breyer, 2004). First, various countries in the region exhibit considerable macroeconomic imbalances. While such imbalances to a certain extent reflect a catch-up process, they may be excessive in some cases and, hence, increase the potential for a sharp reversal. Second, operations in the region have to cope with exchange rate volatility, which, in some cases, has been considerable. Moreover, as the planned dates for EMU accession tend to be postponed throughout the region, exchange rate risks will be around for some time to come. Third, in an environment with rapid credit growth, partial or nonexistent credit histories, and limited experience in credit screening, enforcing proper credit risk standards may be difficult. Lastly, political and legal risks and uncertainties remain in parts of CESE.

65. **Lending in foreign exchange to households adds to the banks' risks.** This practice is prevalent both domestically in Austria, and in the countries in CESE. In Austria, foreign exchange credit is monitored, and efforts at consumer education have been undertaken.[28] In

[28] See for instance the brochure aimed at consumer education on foreign exchange lending, published jointly by the Austrian National Bank (ANB) and the Financial Market Authority (FMA) (Financial Market Authority 2006). In addition, the FMA has mandated minimum standards on granting and managing foreign currency loans (Financial Market Authority, 2003).

CESE, in contrast, such monitoring of foreign exchange credits is less well developed, and consumer awareness of the associated risks is likely lower.[29] Moreover, the number of households in these countries having a natural hedge in the form of foreign exchange income is limited. Although the banks generally apply prudent lending standards to foreign exchange credits, large exchange rate movements may cause the foreign exchange risks for the households to translate into credit risks for the banks. Even though the banks carefully monitor and manage their open positions in foreign exchange, this does not isolate them from credit risk associated with foreign exchange loans.

66. **Two important challenges for the Austrian banks looking ahead are:**

- **First, to preserve high profitability.** To maintain profitability, the banks can focus on revenues, costs, or both. In CESE, although there is some scope for efficiency gains and for an increase in noninterest income, maintaining profitability against the background of declining interest rate margins would primarily require increasing exposures. The banks can do this by increasing risk exposure in countries where they are already present (and where margins are still higher than domestically), by, e.g., moving more funds into profitable retail lending. Alternatively, they can expand their operations to countries where they are not yet present. In particular, many countries further to the east and southeast feature less developed financial systems and potentially larger margins (see, e.g., EBRD, 2006). However, increased exposure to these countries would also increase risk. Expansion into other, more sophisticated international markets, however, also entails risks, for instance when such expansion leads to exposure to complicated and volatile derivative products. On the costs side, adjustments can be made in the short to medium term. In the domestic banking market, in particular, there seems to be further scope for efficiency gains, which could involve further consolidation. Another leap in efficiency could possibly be achieved by further integrating the operations in different countries.

- **Second, to keep risk management and measurement techniques in line with rapid market developments.** The expansion associated with maintaining profitability could increase risks. To manage such risks well, the banks need up-to-date risk measurement and management systems. In addition, to strike a balance between profits and risks, the organizational structure of the banks needs to ensure that risk management considerations are dealt with at the management level. In this context it is also important to note that improved risk management, in particular underwriting practices, leads to lower NPLs, which translate into a more profitable bottom line.

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[29] In addition, such limited awareness could contribute to the risk of herd behavior; see Tzanninis (2005).

E. Implications for Supervision

67. **The challenges for the Austrian supervisors are closely related to these issues:**

- **First, the rapidly expanding activities of the financial sector require close monitoring.** As argued above, the expansion in CESE has helped financial deepening in this region, but the risks involved have grown with the expansion of the activities. In addition, and in preparation for the implementation of Basel II, supervisors need to continue to ensure that the banks use appropriate and adequate risk management and measurement techniques. Specifically, the issue of intragroup risk and capital transfers warrants supervisory attention. Furthermore, it will be important to assess the macroprudential risks associated with the potential impact of macro vulnerabilities (at both national and regional levels) on the banking system, including through stress testing.

- **Second, close collaboration between the Austrian and the host supervisors in CESE is key to effective supervision of cross-border banking groups.** The enlargement of the EU has facilitated cross-border supervisory cooperation with the new member states; particularly useful has been the signing of memoranda of understanding (MoUs) between home and host supervisors regarding exchange of information and cross-border supervisory cooperation with these new member states. Intensifying such supervisory cooperation will remain imperative. In addition, it will remain important to deepen cross-border supervisory cooperation with non-EU member states in which the Austrian financial sector has a significant market share, including the negotiation of MoUs.

68. **In response to these supervisory challenges, the FMA and the ANB have devoted considerable attention to home-host supervisory issues.** A large number of MoUs on supervisory cooperation have been signed, and an active dialogue with foreign supervisors with whom no MoU has been signed (yet) is maintained; this dialogue includes the organization of conferences with, and training sessions for, supervisory authorities in CESE, and the development of a regional supervisory strategy. Interestingly, in this host-home cooperation, the Austrian supervisory authorities fulfill the role of home as well as host supervisor: they are home supervisors for the various subsidiaries in CESE, while at the same time, they function as host supervisor for one of the large Austrian banks owned by a foreign group.

69. **The authorities have concluded many bilateral MoUs on supervisory issues with foreign counterparts.** MoUs have been concluded with counterparts in (in chronological order) France, the Netherlands, the U.K., Italy, Germany, Hungary, Slovenia, the Czech Republic, the Slovak Republic, Croatia, Bulgaria, and Romania. Negotiations to conclude MoUs with Malta, Poland, and Cyprus are ongoing, whereas discussions with regard to possible future MoUs are being held with authorities from Ukraine, Russia, Albania, and

Serbia. These memoranda center on information exchange and examination rights, and stipulate the confidential treatment of information exchanged between the supervisors. They, hence, serve as a basis for a structured and regular exchange of information.[30]

70. **In addition, the Austrian authorities are signatories of the multilateral EU MoUs on cooperation in financial crisis situations (Box 1).** These MoUs, one between banking supervisors and central banks, and one involving banking supervisors, central banks, and finance ministries, primarily arrange for the exchange of information in a crisis situation. They were drafted after the two Brouwer reports on financial stability and crisis management (Economic and Financial Committee, 2000 and 2001) highlighted the need for arrangements additional to the existing EU framework.

71. **While the existing cross-border supervisory arrangements provide a framework for further supervisory cooperation, gaps remain.** The current EU cross-border supervisory framework has not been designed specifically to deal with banking groups that are potentially of systemic importance in several (home and host) countries. In particular, for financial institutions with potentially systemically important operations in one or more host countries, issues can develop between home country lead responsibility for supervision and host country responsibility for financial stability. In addition, the framework for cross-border crisis management remains very much a work in progress (De Nicoló and others, 2005).

72. **To address these issues, the Austrian authorities are increasingly involving their foreign peers in risk assessments of the cross-border activities of Austrian banks.** Currently, the Austrian authorities and their peers in CESE are staging simultaneous inspections at the subsidiaries of one large Austrian bank. Such preparations for joint risk assessments with their foreign peers signify an important step. If successful, this step could be expanded by formally introducing joint risk assessments for all the large cross-border groups, which could then lead to a joint supervisory plan for the group. In addition, against the background of Austrian banks' relatively large exposure to CESE, the Austrian authorities could consider, in due course, conducting joint cross-border crisis management exercises with their counterparts in CESE, in order to assess the current framework for cross-border crisis management.

[30] For some countries where MoU discussions are at an advanced stage but have not been concluded, a similar structured and regular exchange of information takes place.

Box 1. Austria: The EU Framework for Cross-Border Supervision, Regulation, and Crisis Management

Cross-border arrangements consisting of a broad range of Financial Services Directives are embedded in the EU framework. These directives are binding legislation. The current EU framework has evolved from the 1989 Second Banking Directive (89/646/EEC), which introduced the principle of home country control in supervision.

In the current EU supervisory arrangements two directives stand out:

- **The Capital Requirements Directive (CRD, 2006/48/EC and 2006/49/EC) establishes the Basel II capital requirements in European legislation, and introduces a central role for the consolidating or home supervisor in cross-border supervision.** In particular, the CRD gives the consolidating supervisors the power to approve a banks' internal risk models when a joint decision with the host cannot be reached. The CRD also strengthens and clarifies the requirements for information sharing and cooperation among all authorities responsible for the supervision of group entities.

- **The Financial Conglomerates Directive (FCD, 2002/87/EC) introduces a single coordinating supervisor for financial conglomerates.** This way, oversight of, and interaction with, centralized financial conglomerates should be facilitated. A key provision is Article 10, which introduces a coordinator at the group level overseeing the capital adequacy and risk management. The challenge for this single supervisor is to adopt an integrated (that is, banking and insurance) perspective at the group level instead of a sector perspective.

Recognizing potential gaps in the general framework described above, supervisors, central banks, and ministries of finance have concluded several MoUs at the European level aimed at facilitating informational exchange. These MoUs were drafted after the two Brouwer reports on financial stability and crisis management (Economic and Financial Committee, 2000 and 2001) highlighted the need for additional arrangements. The MoUs (one on high-level principles of cooperation among banking supervisors and central banks, and one on cooperation between banking supervisors, central banks, and finance ministries) sketch a general framework for informational exchange both in normal times as well as during a crisis. As such, they mark an important step forward in EU coordination.

Some European supervisors have gone further in bilateral and regional MoUs. The most detailed examples are the MoUs between the Nordic supervisors and the MoU between the Belgian and Dutch supervisors regarding the treatment of individual cross-border operating banks. These MoUs provide modalities for joint risk assessments and supervision. In addition, the Nordic central banks have concluded an MoU on emergency liquidity assistance in case of crises in cross-border banks.

F. Concluding Remarks

73. **The Austrian banks' cross-border activities present several important challenges.** Exposure of the major Austrian banks to CESE is large, as the Austrian banks own a major part of the domestic banking system in many countries in the region and derive a large share of their profits from those countries. This exposure and ownership results in several challenges for the banks, stemming from (i) the pressure to keep up profitability and, (ii) the rapid expansion, including in foreign exchange lending, with which risk measurement and management have to keep pace.

74. **The banks' international expansion also has important implications for the supervisory process.** First, the rapidly expanding activities of the financial sector require close monitoring, as the risks involved are growing with the expansion of the activities. Supervisors need to continue to ensure that banks use adequate risk management techniques, also in preparation for Basel II. Second, close collaboration between the Austrian and the host supervisors in CESE is key to effective supervision of cross-border banking groups; such collaboration would also be important for managing a potential problem in a large cross-border bank. Austria is one of the EU countries that has most to gain from a good cross-border supervisory framework, and the current window of a stable domestic economic environment and solid economic growth, both domestically and in most of CESE, presents a good opportunity to further improve and deepen the cross-border supervisory, regulatory, and crisis management framework. This collaboration should extend to supervisors in both EU and non-EU member states, and include the negotiation of MoUs.

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