

OECD ECONOMIC SURVEY OF THE CZECH REPUBLIC 2004

Excerpt from Chapter 2, Fiscal Policy and Public Expenditure Reform

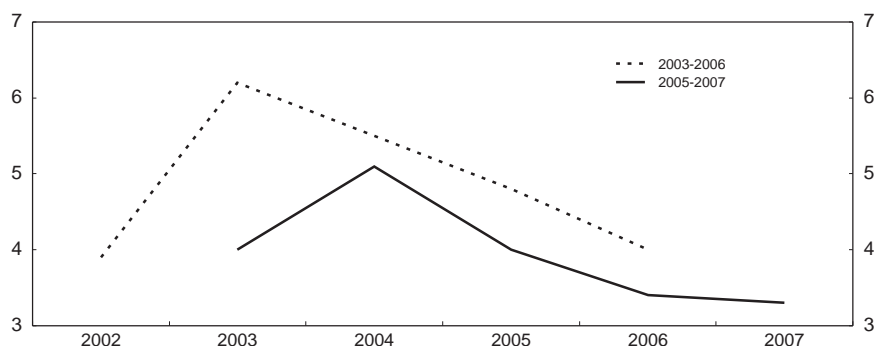
THE FISCAL REFORM PROGRAMME

The fiscal reform programme improves budgetary procedures and starts with tackling the deficit

1. The fiscal reform programme was launched in 2003 when the government proposed a first round of fiscal reforms. The broad objectives of this round of reforms are to improve discipline in spending through a new medium-term budgeting framework, and to make an initial attack on the deficit through a range of active tax and expenditure measures. A second round of reforms is envisaged entailing more fundamental expenditure reforms, most notably through implementation of long-discussed pension and health-care reform. The reforms were outlined in a document on public finance reform in June 2003. The *2004-2006 Budget Outlook* (Ministry of Finance, 2003) submitted to Parliament in September 2003 reflected reform intentions with a new format that included more comprehensive medium-term spending plans than was done previously. A number of the specific tax and revenue measures proposed in the *Budget Outlook* were passed by Parliament in the course of voting the 2004 budget in November 2003. Others have been passed in subsequent parliamentary votes, *albeit* sometimes diluted from original proposals. The legislation for the new budgetary framework was passed by Parliament in August 2004. Details of the first and second-round reforms are listed in **Annex 2.A1**.

2. The *2004-2006 Budget Outlook* of 2003 set out plans for a 4 per cent deficit for 2006 and in the *2005-2007 Budget Outlook* sets plans for a 3.3 deficit per cent for 2007 (**Figure 2.1**). These deficit ambitions closely follow those laid out in the May 2004 Convergence Programme report to the European Commission (Czech Government, 2004).¹ The fiscal reform programme aims to meet deficit targets by active expenditure cuts and revenue increases roughly in the ratio of 2 to 1. On the expenditure side, reductions in employment and wage restraint in the public sector are expected to do a lot of work towards achieving targets along with savings from a reform to sickness-benefit payouts. On the revenue side, active measures to increase VAT and excise revenues are expected to play a key role. In the longer term, savings from planned reforms to health and pension systems are expected to strengthen the sustainability of the consolidation process.

Figure 2.1. **Deficit ambitions in the Ministry of Finance's Budget Outlooks for 2003-2006 and 2005-2007**¹
Per cent GDP, adjusted-cash account



1. The Budget Outlook is a government-approved document that complements detailed budget proposals put before Parliament. The second year of each scenario shown is the estimated deficit outcome (the Budget Outlooks are written in early autumn). The deficits for the following three years are based on calculations of economic conditions and the assumed implementation of active measures indicated in the Budget Outlook.

Source: Ministry of Finance.

Assessing the proposed new budgetary framework

3. The introduction of the medium-term budgeting framework is a welcome step to harden expenditure constraints.² Under this system, the government submits to Parliament, together with the standard state budget, a new document (the medium-term expenditure framework, MTEF) that outlines three-year deficit targets and, importantly, spending ceilings for not only the state budget but also for seven state extra-budgetary funds. The approach in the MTEF is to outline a three-year deficit profile, project a revenue stream (taking into account active measures) and from this derive expenditure ceilings. Key features of the system are:

- The MTEF will be treated the same way by Parliament as the state budget. Importantly, if the document is not approved the draft is returned for revision. The MTEF will be made annually -- and is therefore a rolling medium-term framework.
- The framework stipulates conditions that limit the deviation from the ceilings of the previous year. In particular, the legislation only allows deviations in order to accommodate budgetary rules or in cases of extraordinary macroeconomic conditions.
- The aggregate spending ceiling is the only legally binding ceiling. However, the government aims for detailed chapter-by-chapter information to be provided to Parliament and budget committees and expects chapter administrators to treat constraints as hard, only to be broken in situations of extraordinary and unpredictable expenditure.

4. On paper the introduction of the MTEF looks like a positive step. However, much depends on the strength of commitment to make it work properly. Clear evidence, right from the start that the process is being taken seriously by politicians and bureaucrats is obviously crucial for the process to gain credibility. Success also depends on getting the details right. In this regard the authorities should keep an open mind as to making improvements to the system as its strengths and weaknesses emerge. To this end the authorities should bear in mind the following:

- The system needs to have safeguards against misappropriate use of windfall revenues. Experience in other countries shows there can be a tendency to use “windfall” revenues to initiate

new structural spending programmes. In this regard it is important that the government sticks to its agreement that windfall revenues will only be used for deficit reduction.

- The system needs to ensure there are no avenues to exploit the rules on cyclical spending. For instance, “savings” in unemployment benefit payouts during an upturn may be absorbed by permanent increases in other areas of spending. One solution is to remove the key cyclical items from the expenditure envelope, as has been done, for example, in the United Kingdom.³
- Experience in other countries has shown that spending ceilings can provoke tax expenditure.

Extra-budgetary funds

5. A number of recent steps should improve transparency and budget discipline in extra-budgetary funds -- and this is particularly welcome given that past progress has been rather slow on this front:

- Some important extra-budgetary funds are scheduled to be scrapped, either ceasing to exist altogether, or having responsibilities transferred to central-government officials. Notably, the National Property Fund (responsible for managing privatisation) is set to be liquidated by end-2005 and the Czech Consolidation Agency (responsible for managing bad debt, principally from the banking crisis of the late 1990s) by end-2006. Furthermore, a review is underway to consider the future of the remaining funds.
- The legislated nominal three-year spending caps of the new budgeting system will extend to seven extra-budgetary funds, and will therefore be subject to the same level of spending discipline as central government.
- The introduction of the rule in ESA95 accounting that the full amount of the guarantee has to be reported the moment the guarantee is called for the first time (see above) means guarantees of extra-budgetary funds will be recorded sooner and more comprehensively.

6. Despite this substantial progress, some of the remaining extra-budgetary funds continue to obscure the government’s true fiscal position and all of them should be more fully integrated in mainstream government budgeting procedures. The infrastructure fund in particular creates problems in budget planning because of repeated underspending of budget allocations. The underspending partially reflects unforeseen delays in the implementation of projects. However there is also a suspicion that the managers of the infrastructure fund find it advantageous to bid for high budget allocations -- and are successful in this, in part, because the infrastructure fund’s budget proposal is presented to Parliament as a separate item from the state budget and is therefore not seen in the context of the overall budget (indeed, typically the fund’s budget gets voted in without significant opposition). As the experience in the 2003 budget shows, the underspending means the Ministry of Finance bases public budget estimates and projections on inaccurate expenditures, contributing to a confusing situation for analysts assessing progress towards fiscal targets. The difficulties raised by the infrastructure fund would be at least partly resolved if the process of parliamentary approval was integrated with that for the central budget.

Progress and prospects in active tax and revenue measures

7. The *2004-2006 Budget Outlook* proposed a range of fiscal measures with the aim of passing them through Parliament as part of the 2004 budget or through subsequent legislation. On the revenue side, the most significant proposals were for increases in VAT and excise duty, and reductions in the corporate tax rate. In total the revenue measures were expected to raise CZK 62.7 billion over the three budgets 2004 to 2006 (**Table 2.1**). The *Budget Outlook* estimated that about CZK 190 billion in expenditure savings on the passive scenario would be needed to reach targets and proposed savings in the government’s wage bill through staff cuts as a major component. As can be seen in **Table 2.2** the *Budget Outlook* specified

expenditure measures worth only CZK 121.5 billion between 2004 and 2006; subsequent revision of estimated spending levels, plus government coalition agreement to further cuts, eliminated the gap between the expenditure measures and required spending cuts.

Table 2.1. **Fiscal effects of revenue measures on the State Budget as outlined in the Budget Outlook 2004-2006**
CZK billion

	2004	2005	2006	In total
Total taxes	20.8	22.7	16.5	60.1
Value added tax	10.7	17.2	18.1	46.0
Excise duties	11.8	14.5	17.5	43.8
Corporate income taxes	-4.1	-8.7	-15.7	-28.5
Personal income taxes	-2.4	-1.0	-0.8	-4.2
Other property taxes	4.8	0.7	-2.6	2.9
Social security	-1.0	0.8	2.8	2.6
Total taxes and Social security	19.8	23.5	19.3	62.7

Source: Ministry of Finance, *Budget Outlook, 2003-2006* (2003).

Table 2.2. **Fiscal impact of expenditure measures on the State Budget as outlined in the Budget Outlook 2004-2006**
CZK billion

	2004	2005	2006	In total
Active expenditure measures agreed by coalition in total	25.4	43.5	52.6	121.5
Pensions – parametrical change	-0.1	-0.1	0.0	-0.2
Pensions – pace of valorisation	2.5	4.8	1.3	8.6
Sickness pay	6.1	7.4	8.7	22.2
State social assistance	0.1	0.5	0.7	1.3

Source: Ministry of Finance, *Budget Outlook, 2003-2006* (2003).

Tax measures

8. The key measures on the revenue side of fiscal reform -- changes to VAT rates, increases in excise duty and reduction in the corporate tax rate -- have gone ahead, though with some degree of compromise.

9. In VAT, a range of services were moved from the “reduced rate” of 5 per cent to the “standard rate” of 22 per cent in January 2004, including notably telecommunications (**Annex 2.A1**). More shifts were made in May 2004, but not as many as were aimed for in the second tax package agreed in February 2004. Notably, a VAT increase on hotel services has been postponed and planned increases on a number of items including water, sewage and cultural events have been cancelled altogether. In addition it was decided to lower the standard VAT rate from 22 to 19 per cent and to introduce one-off compensation to households for the VAT-related price increases (neither of these measures was in budget proposals). The compensation package includes increases in parental allowances and one-off payments to all pensioners and families. As of June 2004, it was estimated the VAT reforms will raise revenue equivalent to about 1.2 per cent of GDP, and that the compensation package will cost about 0.3 per cent of GDP.

10. Various excise duties were increased on 1st January 2004, including increases in duty on retail petrol and diesel, alcohol and cigarettes. The increases in the latter are driven by EU directives and are the

first in a series of increases that are scheduled to increase the excise duty to the equivalent of EUR 60 per 1000 cigarettes by 2007.⁴

11. Corporate tax was reduced from 31 per cent to 28 per cent on 1st January 2004, the first of three cuts that will bring the rate to 24 per cent in 2006. The cut was partly offset by base-broadening measures, including a reduction in the period allowed to carry losses forward from 7 to 5 years and abolition of a tax credit on withheld taxes on dividends. At the same time, however, new tax expenditures are envisaged. At the beginning of 2005, it is aimed to increase depreciation rates on assets and to raise the maximum tax deduction on R&D spending.

12. The fiscal reform programme also envisages tax expenditures on families. It is aimed to introduce an optional joint taxation scheme for married couples with children (see **Chapter 5**). In addition it is hoped to replace the child tax deduction with a tax credit. There are also plans to introduce a cap on social contributions for those earning more than five times the average wage.

13. The implemented tax changes obviously bring much-needed revenue increases and help towards narrowing the deficit -- even though in the case of VAT the revenue impact will be less than was originally hoped for. In planning further tax measures the authorities are recommended to:

- Improve the efficiency of the tax system through reduction in targeted tax breaks for business to create room for tax cuts elsewhere, for example in the corporate tax rate or in the tax wedge on labour. The tax breaks are distorting and not very transparent for investors. Cuts in the corporate tax may be a desirable way of using the savings made because of concerns to maintain competitive effective rate of business taxation as well as make the “headline” rate of business tax more attractive. Compared with the Czech rate of 28 per cent (scheduled to be 24 per cent in 2006), the Polish and Slovak rates are currently 19 per cent and the Hungarian rate has recently moved from 18 to 16 per cent.
- Focus cuts in the tax wedge more on low-income households so as to increase demand and supply for jobs in the segment of the labour market where unemployment is most prevalent. The introduction in the cap on social-security contributions does indeed cut the tax wedge but addresses a relatively low policy priority, benefiting high income earners (and their employers) where supply and demand elasticities are low. The proposals to cut taxes for low-income households as part of the second-phase of structural reform are therefore welcome (**Chapter 5**).
- Create opportunities for cuts in the tax wedge by more fully exploiting under-utilised tax bases, notably tax on property. Greater flexibility and revenue potential in local property taxation would broaden the tax base and improve income options for local government. At present property-tax revenue is relatively low in international comparison. 2001 figures, for example, show revenue to be only 0.2 per cent of GDP; in many other European countries revenue is much higher. This being said, the authorities would have to be careful in the design of any new property tax system to avoid the problems that are often seen in this form of taxation elsewhere.

Expenditure measures

14. Progress in implementing the fiscal reform’s expenditure measures has so far been reasonable. Reforms in the sickness benefit system, estimated to yield about CZK 20 billion between 2004 and 2006, have gone ahead as planned. In addition some progress has been made on the much larger cuts in the government’s wage bill. A specific group of top public officials including MP’s, ministers and judges have had a wage freeze imposed and savings from integrating 13th and 14th month payments into standard

monthly wages for all public employees are set to go ahead in 2005. In addition, the authorities made some progress in the goal to cut public-sector employment by 30 000 between 2004 and 2006.

15. However, there are signs that the hoped for economies in the public-sector wage bill may fall well short of those planned. There are reports that budget planning for 2005 may aim for far fewer job cuts than are needed to reach the target cut in public-sector employment. In addition large wage increases for the police, customs officers and firemen have been agreed for 2005 that were not factored in to the original fiscal-reform plans. These risks to the achieving expenditure goals need to be countered by reinforced commitment to the planned cuts in employee numbers and the authorities might also consider additional saving measures to offset the unplanned increases in the public-sector wage bill.

ENDNOTES

1. The May 2004 Convergence Programme report sets out goals in ESA95 general government accounts of 4.9 per cent deficit in 2005, 4 per cent in 2006 and 3.5 per cent in 2007.
2. The legislation for the new medium-term expenditure framework is part of an amendment to the Act on Budgetary Rules and was effective from August 2004.
3. The UK budgeting system sets hard three-year departmental budget constraints except in areas where cyclical and other influences make hard constraints difficult to implement (*e.g.* social-security benefits, tax credits). These areas of spending are subject to a separate system of targets and monitoring.
4. EU Directives on excise duty on cigarettes stipulate that i) the excise duty must be at least 57 per cent of the final retail price and ii) that the duty must be at least EUR 60 per 1 000 cigarettes (this latter condition is the more relevant in the case of the Czech Republic). The Directives must be fulfilled by 1 January 2007.

BIBLIOGRAPHY

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Ministry of Finance (2004), *Convergence Programme of the Czech Republic*, May.