3 General Government Balance and Debt

General government finances were in past years positively influenced especially by the peak phase of the economic cycle. The recession at the turn of 2008 to 2009 deteriorated results and thus showed the structural character of the fiscal imbalance. The 2009 deficit reached 5.9% of GDP, while in 2010 it was successfully reduced to 4.7% of GDP by strong active measures. Nevertheless, general government indebtedness increased by 8.5 percentage points from 2008 to 38.5% of GDP in 2010. The current consolidation strategy counts upon further decreasing the deficit, by an average 0.7 percentage points annually, which should slow growth in the debt-to-GDP ratio.

3.1 Actual Balances and Updated Budgetary Plans for the Current Year

According to current estimates of the Czech Statistical Office, the general government deficit reached CZK 173 billion in 2010, which is 4.7% of GDP. In contrast to 2009, there was a recovery of revenues, which after two years of decline and stagnation started growing again. The development on the revenue side was related to the gradual economic recovery and to tax-related measures valid from early 2010 (see Chapter 1.2.1). Thus, the established trend of shifting the tax burden from direct to indirect taxes continued. On the expenditure side, there was a decrease of grants, capital transfers, gross capital formation and also, due to the lower volume sold of assigned amount units[4] of CO_2, net acquisition of non-manufactured non-financial assets. Moreover, austerity measures were taken at the central government level (a decrease of compensation to employees and intermediate consumption), i.e. for expenditures related to state administrative operations. The growth rate of social benefits was significantly reduced and thus mandatory expenditures increased less than before.

Very positive development was apparent in interest costs, which grew only moderately despite relatively high debt dynamics. This fact can be attributed especially to a decrease in interest rates for all issued maturities of the government bond yield curve and to stabilisation of the risk premium for Czech government bonds, at least in comparison with most EU countries and also in contrast to 2009. This reflects a positive assessment of the consolidation strategy implemented in the Czech Republic.

For 2011, the Ministry of Finance of the Czech Republic expects the deficit to decrease to CZK 154 billion (4.2% of GDP). Thus, fiscal consolidation is expected to be in the extent of 0.5 percentage points; after adjusting for the cyclical component and one-off factors, the fiscal effort is even 0.9 percentage points. The revenues side will probably be strengthened by faster growth of certain tax incomes such as VAT and corporate income tax. VAT collection is influenced by the increase of rates from 2010, which will apparently only become significantly evident this year. For corporate income tax, the influence of accelerated depreciation can be seen. Moreover, the corporate income tax is also influenced by a decrease of the statutory rate in 2010. In view of the system of tax advances and the timetable for submitting returns, an improvement is expected on an accrual basis. Taxes on products are influenced by the payments from solar electricity production which were newly introduced in 2011. Property taxes will record a leap upward. This is caused mainly by introduction of the gift tax on unpaid acquisition of greenhouse gas emission permits.

Revenues from European funds are reaching their historically highest levels, and we assume only their moderate increase. These resources influence the balance only through their national financing part. They have considerable influence on the development of government investments, wherein they are to a considerable degree replacing national funds.

Growth dynamics on the expenditure side of the general government sector are lower than on the revenue side. According to the current assumptions, there will be an increase of other production subsidies in contrast to last year due to increase of subsidies to operators of the electricity transmission and distribution systems. Their aim is to eliminate the increase of electricity prices caused by the guaranteed purchase price from renewable sources and the large increase in the number of photovoltaic power stations. Due to the government's effort to increase the Czech Republic's absorption capacity for co-financing private projects from European funds there is an increase of investment grants to other sectors.

A risk on the expenditure side of general government budgets is the possibility for acceleration in the interest costs of the government debt, where a deterioration of last year's conditions can be expected. Due to

[4] Assigned Amount Unit (AAU) is a unit defined within the Kyoto Protocol, representing a state's tradable right to emit one tonne of greenhouse gases during 2008–2012. The Czech Republic has at its disposal according to the Kyoto commitment the right to emit in the given period a total of approximately 900 million tonnes of CO_2. Any country decreasing its emissions more that it committed to in the Kyoto Protocol can sell the surplus of its units to other countries. According to current analyses, the actual emissions will be approximately 17% below the Czech Republic's targets.

the considerable volatility in financial markets, this item represents a potential risk especially for the state budget.

A moderate increase is expected for social transfers. In contrast, the most significant decline on the expenditures side can be expected in outlays for compensation of employees, where in 2011 the wage policy measures and reduction in the number of employees in the central government administration will manifest themselves.

Risks to the presented deficit estimate and forecast for general government for 2010 and 2011 can be seen in the estimates of gross fixed capital formation, which are founded especially on the accounting reports the precision of which will be increased using data inputs from subsequent statistical surveys.

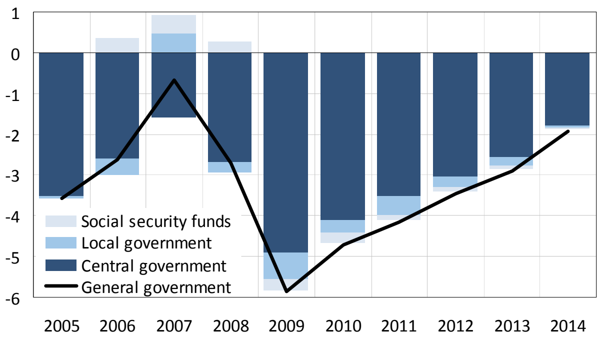
We estimate the general government debt at the end of 2011 at 41.4% of GDP, thus still remaining below the Maastricht convergence criterion and Stability and Growth Pact reference value.

3.2 Medium-term Budgetary Outlook

The medium-term budgetary outlook for 2012–2014 assumes further gradual improvement of the general government balance to –1.9% of GDP in 2014 (see Chapter 1.2.3). The current fiscal policy setting is defined by the government-approved expenditure frameworks and by the agreed targets for the deficit trajectory.

General government finances are strongly influenced by the central government balance (Chart 3.1), which will most likely hold in the future, since we assume decreasing contributions to the deficit from institutions standing outside of the central government.

Chart 3.1: Government Balance by Sub-sectors
(in % of GDP)



Note: Years 2010–2011 show notification. Years 2012–2014 show outlook.
Source: CZSO (2011b). MF CR calculations.

The following subsections analyse the main factors influencing the revenue and expenditure sides separately. General government finances will be influenced not only by the expected gradual acceleration of economic output, but also by discretionary and reform changes either approved or expected to be approved.

3.2.1 Expected Revenue Development

From the fiscal viewpoint, one of the most important changes will be the increase of the reduced VAT rate by 4 percentage points in 2012 and then its unification to 17.5% in 2013. VAT collection, normally tracking the development of household and government consumption, should therefore increase by CZK 27 billion next year. We expect the year-on-year change in collections to be far less in 2013 due to the decline of the basic rate by 2.5 percentage points. Decrease of the registration limit for VAT payers by one quarter will also have a positive effect on tax collection (see Chapter 6.1.1).

Excise taxes will most probably grow only moderately, as the only significant positive change is an increase of tax rates on tobacco products in 2012 due to harmonisation with EU law.

For corporate income tax collection, we expect also only moderate growth from 2012 on, at first still positively influenced by the expiration of measures which allowed the taxpayers to shorten the depreciation period for assets in the first and second depreciation groups in 2009 and part of 2010. Tax collection in 2012 will be favourably influenced (ca CZK 7 billion annually) by taxation of lottery operators and of other gambling. In the later years we do not assume more significant growth, because, especially in connection with the tax reform, measures which will decrease revenues will come into effect. Among these, there is the possibility for tax paid from dividends to be granted a tax credit (fallout of approximately CZK 7 billion) or the possibility to increase the gift limit as a deductible item from the tax base or a zero rate for investment and pension funds. In connection with the tax reform, the decrease of the obligation to pay insurance premiums for employees can be considered a positive factor for corporate income tax, resulting in a lower level of costs and, ceteris paribus, higher taxable income. However, we do not estimate the extent of this effect to be greater than CZK 3 billion.

The autonomous personal income tax development is predicated upon a moderately optimistic outlook for evolution in the volume of wages and salaries. The accrual tax revenue in 2012 will be negatively influenced by an increase of the child credit, which is related to the planned pension reform and which should serve to compensate growth in prices of goods and services under the reduced VAT rate (fallout of CZK 4 billion). The legislative form of the new act on income taxes will have a significant negative impact. Due to changes in statutory rates, the tax base and introduction of a new credit for payers with income from employment and fringe benefits, revenue is expected to decrease by CZK 18 billion from 2013. On the other hand, cancellation of certain tax exemptions should have a positive impact under the tax reform (approximately CZK 5 billion).

The group of property taxes, specifically the gift tax, will record a decrease by approximately CZK 4.5 billion in 2013, as the validity of the amendment that taxed emission permits allocated free of charge will expire.

The largest sources of income for the Czech Republic's public budgets are without question the contributions to health and social insurance (in 2010 accounting for almost 39% of total revenues). In addition to development in the volume of wages and salaries, the planned tax reform will determine contributions to health insurance. Apart from the statutory transfer of part of the burden from the employer to the employee, which in itself will not bring higher income from the insurance premium, incomes under contracts for services over CZK 5,000 will be newly taxed. We estimate the additional revenue from this measure to be CZK 0.9 billion.

More changes will occur in contributions to social security. The most significant of these will be the possibility to exclude 3 percentage points of the contribution from the pay-as-you-go pillar to the second pillar of the pension system (see Chapter 5.2.2). Since it is now very difficult to accurately specify what percentage of people will decide to diversify their old age security sources and what income profile this group of people will have at their disposal, we consider – taking a conservative view – the more pessimistic variant which works with a fallout of CZK 20 billion per year. For self-employed persons, there is additional fallout of CZK 12 billion due to a change of contribution rates and of the contribution assessment base. In contrast, as is the case for health insurance, there will be a positive effect from taxation of income under contracts for services of over CZK 5,000 (revenue CZK 1.7 billion).

Concurrently with the tax reform, the system of employer's accident insurance will also be adjusted, where a possibility is being considered to continue its operation outside the public sector and without tying its financial results to the government sector. In such a case, the government balance would decrease by CZK 2.7 billion per year.

The impacts of the tax reform are summarised in Table 3.1. In general, it can be said that although the reform reduces direct taxation and taxation of labour, and from a long-term point of view it can therefore be considered entirely positively, it generates, per se, deficits of 0.2% of GDP in 2013 and 0.6% of GDP in 2014. Exceptional is only the year 2012, when a number of measures will not yet be in effect (apart from the taxation of gambling – see above).

Measures in connection to the pension reform will have in the following year an entirely positive effect on the balance of government institutions (ca CZK 23 billion). The increased VAT revenue should serve to cover deficits on the pension account. It could therefore decrease the total general government deficit by 0.6% of GDP in 2012. In the following years (see Table 3.2) the expected impact is more or less zero.

Among other changes on the revenue side, there is the already valid lowering of ceilings for contributions to social security back to the amount of 48times the average wage from 2012, which will decrease the revenues by approximately CZK 3.1 billion. And last but not least, also in 2012, motorway toll rates will increase by 25% (additional revenue of CZK 1.4 billion). Their gradual increase according to inflation is being considered. In 2014, expiration of payments introduced for some solar power plants will have a negative effect.

Of the non-tax revenues, the income from selling EU emission permits cannot be disregarded, the precise amount of which will depend both on the exchange rate of the Czech koruna to the euro and also on the price per permit. We currently estimate that the revenue from approximately 50% of permits sold in 2013–2014 can be in the range of CZK 12–15 billion.

Table 3.1: Impact of the Tax Reform on the General Government Balance
(in CZK billion)

		2012	2013	2014
Personal income tax	*bill. CZK*	**0.1**	**-12.5**	**-13.0**
Corporate income tax	*bill. CZK*	**7.0**	**3.7**	**3.7**
Social security contributions	*bill. CZK*	**-**	**1.7**	**-10.3**
Health care contributions	*bill. CZK*	**-**	**0.9**	**0.3**
Accident insurance	*bill. CZK*	**-**	**-2.7**	**-2.7**
Total impact on balance	*bill. CZK*	**7.1**	**-8.9**	**-22.0**
Total impact on balance	*% of GDP*	**0.2**	**-0.2**	**-0.6**

Source: MF CR calculations.

Table 3.2: Impact of Pension Reform Measures on the General Government Balance
(in CZK billion)

		2012	2013	2014
Value added tax	*bill. CZK*	**27.0**	**31.9**	**33.4**
Personal income tax (increase of deduction for children)	*bill. CZK*	**-4.0**	**-4.0**	**-4.0**
Social security contributions (opt-out)	*bill. CZK*	**-**	**-20.0**	**-20.0**
Pensions	*bill. CZK*	**-**	**-3.5**	**-3.5**
Compensation of higher VAT rate to those in social and material need	*bill. CZK*	**-**	**-0.1**	**-0.1**
Higher public expenditure in relation to the reduced VAT rate increase	*bill. CZK*	**-**	**-5.0**	**-5.0**
Total impact on balance	*bill. CZK*	**23.0**	**-0.7**	**0.8**
Total impact on balance	*% of GDP*	**0.6**	**0.0**	**0.0**

Source: MF CR calculations.

3.2.2 Expected Development of Expenditures

On the expenditure side, there will also be several important changes in connection to the measures being prepared. From measures already in effect, there is a decrease in the state subsidy for building savings, which should bring savings in mandatory expenses of approximately CZK 4 billion per year.

In addition to a 10% reduction in the wage bill and optimisation of the number of jobs in 2011, the consolidation effort in the public administration is further supported by maintaining the nominal level of wages for the outlook's entire duration (2012–2014). Nevertheless, wage increases are planned in some areas of general government, especially in education (CZK 4 billion in 2012) and health care (CZK 1.5 billion in 2012–2013) with a promise of better quality of services produced by these systems. In total, we expect mean growth in the volume of wages and salaries in general government by 1.2% for 2012–2014.

Amendment of the act on pension insurance, which is currently being discussed by the Chamber of Deputies of the Parliament, will also have a positive effect. This should prevent populist efforts to valorise pension insurance benefits above the mandated amount at the end of the election cycle. Moreover, it will make the system more regular and predictable. Therefore, we expect monetary social security benefits to rise only by 2.5%. Year 2013 will be an exception, when they will probably increase by 4.5% due to valorisation covering, among other things, the increase of prices caused by raising the reduced VAT rate (see Table 3.2).

In the case of social transfers in kind, higher co-financing of health care and payment by public health insurance only for the basic standard of care are expected, as intended by the health care system reform (Chapter 5.2.3). For this reason, the volume of social transfers in kind will grow only very modestly. For the remaining social transfers, the average growth will be only 2.7% as a result of the consolidation of public finances and of reform of the labour market and the social domain.

A considerable part of the savings realised in public finances should occur in government consumption, which will be significantly affected by planned revision of the ministries' agendas and their expected reduction by 5%. Savings will be about CZK 15 billion per year.

Some items on the expenditure side will be to a certain degree influenced also by the higher reduced VAT rate (for example, spending on medicaments, operating outlays), the impact of which on total expenditures of general government is expected to be approximately CZK 6 billion. Nevertheless, a certain part of these expenditures will be financed by inherent reserves and system savings, so the final impact to the overall balance shall be around CZK 1 billion lower.

The single collection point (see Chapter 7.2 for more details) will bring not only savings of administrative expenses to the taxpayers and simplification of the entire tax administration system, but also savings on the side of the public sector budget (approximately CZK 1 billion at the project's outset and nearly three times that in the project's final phase in 2014).

The consolidation effort is also noticeable in intermediate consumption, the growth of which should decelerate from 4.4% in 2012 to stagnation in 2013–2014.

Alternative financing modes are being sought for gross fixed capital formation (see e.g. Chapter 6.3) and for increasing the efficiency of the public contracts system, which should be interconnected with the gradually implemented State Treasury system. Total savings can thus be CZK 5–10 billion.

The development of expenses for interest payments should stabilise after transitional expected growth of nearly 25% in 2011, reflecting on the one hand the year-on-year decreasing general government deficit and on the other hand stable, relatively low interest rates for state bonds. The growth in interest payments should not therefore exceed 3% per year. Also a proposal for central management of state liquidity is being considered. It would include surplus liquidity on the accounts of state funds, municipalities and regions. This should decrease expenditures for debt service by approximately CZK 4 billion annually.

Table 3.3: Measures for Optimising and Increasing Efficiency of the State Administration

		2012	2013	2014
Revision and reduction of ministries' agendas by 5 %	*bill. CZK*	-	15.0	15.0
Single Collection Point	*bill. CZK*	0.4	0.6	1.0
Central management of state's liquidity via including accounts of SFs, regions and municipalities	*bill. CZK*	-	4.0	4.0
Increase in effectiveness of public procurements	*bill. CZK*	-	5.0	10.0
Total impact on balance	*bill. CZK*	0.4	24.6	30.0
Total impact on balance	*% of GDP*	0.0	0.7	0.8

Source: MF CR calculations.

3.2.3 Comparison of Intentions with a No-policy-change Scenario

The presented intentions of fiscal policy relate to both reforms of a structural character and also changes purely related to the budget, with the aim to limit the size of the public sector while simplifying and making it more efficient. They have been arranged so that the medium-term expenditure frameworks are not surpassed and at the same time so that the targets for the general government sector deficit relative to GDP are met.

The outcome for autonomous development of public sector finances with unchanged policies and in the absence of the stated corrective measures is summarised in Table 3.4. It shows that without proposed measures the general government deficit would be higher by approximately 0.7 percentage points on average, which is, in absolute terms, an amount just under CZK 30 billion.

Although at first glance the differences among the scenarios in the given years could seem similar, the division between revenues and expenditures will show the changes in the structure and character of consolidation over time. While 2012 is significantly influenced by higher revenues (especially the increased reduced VAT rate), 2014 will almost exclusively accentuate the expenditure side. Year 2013, then, stands almost on the border line, with 57% of active measures directed to the expenditure side.

Table 3.4: Comparison of the No-policy-change Scenario with the Intentions of Fiscal Policy

		Autonomous scenario			Forecast incl. proposals		
		2012	2013	2014	2012	2013	2014
Total revenue	*% GDP*	41.4	40.8	40.0	42.3	41.1	40.1
Total expenditure	*% GDP*	45.7	44.4	42.5	45.7	44.0	42.0
General government balance	*bill. CZK*	-167.4	-147.4	-110.2	-135.0	-118.8	-83.5
General government balance	*% GDP*	-4.3	-3.6	-2.5	-3.5	-2.9	-1.9

Source: MF CR calculations.

3.3 Structural Balance, Fiscal Stance

The structural balance in 2011 will reach −3.1% of GDP, and during 2012–2014 it will gradually improve due to the consolidation measures towards −1.6% of GDP. However, as Chart 3.2 shows, the quickly decreasing structural balance should be driven by decrease in the primary structural component, while interest expenses will probably constitute a rather stable 1.7% of GDP throughout the entire period. In order to reach the objective that the total balance is in the region of −1.9% of GDP in 2014, therefore, it will be necessary to completely balance the primary structural balance.

Among one-off and other transitional measures during 2009–2012 are one-off revenues from sales of emission permits assigned amount units and the related expenses, as well as the capital transfers expenditure to non-standard state guarantees in the amount of not more than CZK 2 billion per year throughout the entire forecast horizon. As a proportion of GDP, these are (especially at the end of the period) more or less negligible.

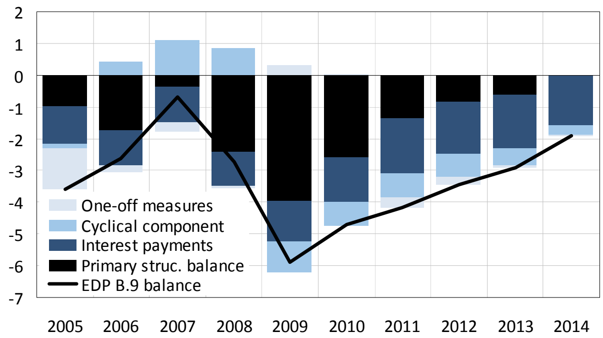
Chart 3.2 (and in more detail, Table A.5) also presents the cyclical components of the deficit, i.e. items that are sensitive to the economy's position in the business cycle. With the economy's gradual recovery, their negative influence diminishes from −0.8% in 2011 to −0.3% in 2014.

Fiscal effort, defined as the year-on-year change in the structural balance, is positive across the entire forecast horizon and its annual average during 2010–2014 reaches 0.7 percentage points. Therefore, we estimate the total fiscal effort in the given period to be 3.6 percentage points, which should ensure reaching the commitments ensuing from the Stability and Growth Pact and the requirements of the Council from the EDP (see Chapter 1.2).

The forecasted development shows that, according to the actual output gap estimate and the tax revenue prediction, lesser fiscal effort will not make the reduction of the government sector deficit below 3% of GDP possible in 2013.

Chart 3.2: Decomposition of the General Government Balance

(in % of GDP)



Source: CZSO (2011b). MF CR calculations.

3.4 General Government Debt, Strategy and Stability of the State Debt

The expected scenario for the development of public finances indicates growth in the nominal general government debt during the entire forecast period. Nevertheless, due to higher nominal growth in GDP we expect (Table 3.5) culmination of the debt-to-GDP ratio in 2013 at 42.8% of GDP and then its decrease to 42.0% in the following year. The scenario assumes a decreasing share of the primary balance on changes in the debt ratio, while the interest expenditures will increase it by approximately constant contributions of around 1.6 percentage points (Table A.4). Within the forecast horizon, we consider no new privatisation revenues.

The central government institutions sub-sector has the most substantial share in the total public debt, accounting for more than 93% of total debt. The local government institutions sub-sector represents the remaining approximately 7% of total debt, as indebtedness of the social security funds is negligible.

Nearly all of the central government debt, then, is accounted for by state debt. Therefore, its sustainable risk structure is an important stability factor for the general government.

When shaping the medium-term debt and the state's issuance strategies, main attention is focused on refinancing and market risk, representing the most important sources of financing uncertainty. Their stabilisation has been shown as crucial especially in periods of above-average volatility on international financial markets and increased uncertainty among investors. The strategy's long-term target has been to reduce the proportion of short-term state debt (i.e. debt payable within one year) from the 69% in 2000 to below a threshold of 20% and to maintain that in the coming years. This is a key stabilising element in financing the central government's borrowing needs and planning issuance activity on domestic and foreign markets.

The stable refinancing structure is also confirmed by the average maturity of the state debt (see Table 3.6). In past years, this indicator ranged from 6 to 7 years. In 2009 and 2010, the lower threshold of the average maturity (due to increased uncertainty on world financial markets) was decreased by 0.5 year, putting it in a range of 5.5–7 years. The improving situation on the global financial market and improvement in the Czech Republic's fiscal position allowed for adjusting this range in 2010 to 5.25–6.25 years for all years of the outlook.

As at the end of 2010, the state debt's structure in terms of interest paid on debt instruments generated an exposure to a change in interest rates on a one-year horizon of 31.7% of the state debt (debt with interest rate refixing up to 1 year). The interest-rate exposure expressed in this way has hovered around the aforementioned value since 2004. In terms of the debt portfolio's stability, this constitutes a threshold which can be regarded as relatively safe and comparable with the international practice of developed countries. For 2011–2014 the range for debt with interest rate refixing up to 1 year has been set to 30–40%.

In terms of interest-rate structure, the proportion of variable interest rate long-term instruments grew in 2008 and 2009 (Table 3.6). During 2011–2014, the share in the total debt of debt with variable interest rate is expected to be above 12%. The effect of derivative transactions on interest rate exposures relates to operations hedging the currency risk for foreign issues.

It can also be derived from the amount and structure of the state debt that a rise in interest rates by an average of one percentage point along the entire yield curve would lead to a rise in interest costs of the state debt issued before 2011 by approximately CZK 4.3 billion.

Table 3.5: General Government Debt by Sub-sector
(in % of GDP)

	ESA Code	2009	2010	2011	2012	2013	2014
General government	S.13	**35.4**	**38.5**	**41.4**	**42.4**	**42.8**	**42.0**
Central government	S.1311	**32.7**	**35.9**	**38.8**	**40.0**	**40.6**	**39.8**
Local government	S.1313	**2.7**	**2.6**	**2.7**	**2.5**	**2.4**	**2.2**
Social security funds	S.1314	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**

Note: Years 2010–2011 show notification. Years 2012–2014 show outlook.
Source: CZSO (2011b). MF CR calculations.

Table 3.6: The State Debt's Refinancing and Interest

		2009	2010	2011	2012	2013	2014
Refinancing							
Average maturity	*years*	**6.5**	**6.3**	**6.0**	**5.8**	**5.8**	**5.8**
Debt due within 1 year	*% of debt*	**14.7**	**16.1**	**17.6**	**17.9**	**18.8**	**19.0**
Financing reserve/debt due within 1 year	*%*	**33.8**	**30.1**	**11.7**	**9.0**	**6.4**	**6.1**
State debt's interest							
Debt with interest fixation within 1 year	*%*	**30.5**	**31.7**	**33.0**	**34.3**	**33.1**	**33.9**
Fixed interest long-term debt due within 1 year	*%*	7.0	7.5	4.5	7.0	6.6	6.8
Variable interest long-term debt	*%*	13.1	12.1	14.8	12.1	12.2	12.7
Monetary instruments	*%*	7.5	8.4	9.9	10.8	11.4	12.1
Effect of derivative operations	*%*	3.0	3.6	3.8	4.3	2.9	3.0

Note: The state debt here represents debt generated by the state budget financing. Data in the national methodology.
Source: MF CR calculations.