

## 6 Quality of Public Finances – Revenues and Expenditures

### 6.1 The Government's Strategy

In 2003, the Czech government launched a public finance reform focusing on fiscal consolidation and elimination of the public budgets' deficit tendency, increasing the flexibility of fiscal policy and strengthening the long-term sustainability of public finances.

The reform measures, together with favourable economic development and partial expenditure savings, contributed to the positive results of general government finances, a reduction in the deficit's share in GDP from 6.8% in 2002 to 3.5% in 2006 and to preventing any rise in the public debt's share.

Despite strong GDP growth and meeting the fiscal target set in the CP for 2005, the general government's outlook has deteriorated in year-on-year terms. In particular, this deterioration is at the expense of accelerated expenditure growth of primarily a mandatory nature in the social sphere. In spite of the gradually declining costs associated with transformation and the anticipated continuation of robust GDP growth of around 4.8%, the fiscal target from the last CP for 2007 to 2008 may in all probability not be met.

Nevertheless, the government will once again achieve a decline in the deficit's share in GDP for the 2008 and 2009 outlook, which is a part of the 2007 state budget. The key priority still focuses on the gradual reduction of the general government deficit to under 3% of GDP, ending the current excessive deficit procedure and in turn reaching the medium-term budget objective of a deficit of 1% of GDP. For renewing the process of fiscal consolidation, it will be necessary, in addition to continued GDP growth, to implement austerity measures on the expenditure side, among others, in view of the fact that the tax quota will have a tendency to decline autonomously on the revenue side after the tax measures from 2004 to 2006 have died out.

The main points of the medium-term fiscal strategy are contained in the Economic Growth Strategy and the National Reform Programme from 2005. This involves upholding the principles of fiscal targeting and strengthening the medium-term expenditure frameworks, restructuring the expenditure side of public budgets, continuing to restructure the tax burden, preventing the onset of indirect indebtedness in the form of extra-budgetary fiscal risks and prioritisation of strategic decisions for stabilising the pension system and the healthcare financing system.

### 6.2 Public Expenditures

As a part of the public finance reform, the government has focused on the goal of restructuring the expenditure side of public finances in order to widen the manoeuvring space for fiscal policy performance, increase the expenditures for programmes with positive growth effects (infrastructure, education, research, development and innovation) and to ensure sufficient resources for co-financing projects with EU funds.

## 6 Quality of Public Finances – Revenues and Expenditures

Succeeding in these priorities is a condition for reducing the share of mandatory expenditures in public budget expenditures and in turn increasing the effectiveness of allocated resources. One of the main instruments for improving the quality of public expenditures will be the introduction of programme budgeting (see Section 8.1).

**Table 6.1: General government expenditures**

% of GDP	ESA code	Year 2005	Year 2006 (1)	Year 2007 (2)	Year 2008 (2)	Year 2009 (2)
<b>Components of expenditures</b>						
<b>Collective consumption</b>	<b>P.32</b>	11,2	10,9	10,6	10,3	10,1
<b>Total social transfers</b>	<b>D.62+D.63</b>	22,7	22,6	23,0	23,0	22,7
<b>Social transfers in kind</b>	<b>D.63</b>	11,2	11,0	10,9	10,9	10,7
<b>Social transfers other than in kind</b>	<b>D.62</b>	11,5	11,6	12,1	12,1	12,0
<b>Interest expenditure</b>	<b>EDP D.41</b>	1,2	1,2	1,4	1,5	1,5
<b>Subsidies</b>	<b>D.3</b>	1,9	1,9	1,9	1,8	1,7
<b>Gross fixed capital formation</b>	<b>P.51</b>	5,0	5,1	5,2	5,6	5,7
<b>Other</b>		2,2	1,8	1,8	1,7	1,7
<b>Total expenditures</b>	<b>TE</b>	44,0	43,4	43,9	43,9	43,4
<b>p.m.: Compensation of employees</b>	<b>D.1</b>	8,0	7,7	7,6	7,4	7,2

(1) Estimate

(2) Outlook

Source: Ministry of Finance (2005 calculation of the Ministry of Finance from Czech Statistical Office sources)

At the end of 2005 and the beginning of 2006, a number of new acts were adopted in the area of social mandatory expenditures, which make up the largest part of the state budget. These measures relate to previously taken steps, such as suspending the valorisation of sickness benefits, permitting a combination of proceeds and collection of parental contributions or the entitlement to social benefits conditioned by the duty to accept eight hours of public service work per month. However, the budget is burdened by additional mandatory expenditures. The adverse fiscal effects related to these legislative changes slow down the restructuring of the expenditure side. The expected negative impact of these measures on the general government deficit exceeds the expected 1% of GDP in the individual years. An overview of these measures and the calculation of their assumed impact are presented in Box 6.1 and Table 6.2.

The measures which would more substantially reduce the share of mandatory expenditures in GDP have not yet been fully implemented. To create more space for additional expenditure priorities, it will, therefore, be necessary to increase social mandatory expenditures in upcoming years at a lower rate than nominal GDP growth.

The 2007 state budget expects to contribute an overall amount of CZK 25.1 billion to expenditures for supporting research and development as a priority area of the National Reform Programme. So the share of these expenditures in nominal GDP for 2007 will reach 0.7% and will register an annual increase in absolute terms of CZK 6.9 billion or 37.9%.

### Box 6.1: Changes in social security

#### **Sickness insurance expenditures**

The new Act on Sickness Insurance set forth the obligation of employers to pay wage compensation to employees for the first 14 days of work disability due to sickness. This act comes into effect on 1 January 2008. The valid version proposes for 2008 a 50% refund of the employers' financial obligation from the state budget. In addition, there should be a gradual reduction in the rate for employers' sickness insurance contribution from the current 3.3% in 2007 to 2.3% in 2008 and to a target rate of 1.4% in 2009. The old system will still be valid in 2007. In 2008, expenditures will decline by CZK 2.9 billion and by CZK 8.4 billion in 2009. However, due to a decline in contribution revenues, the overall impact on the state budget will be negative during the indicated years (CZK 7.6 billion in 2008 and CZK 12.1 billion in 2009).

#### **Government welfare benefits**

Changes to government welfare benefits include increasing the parental contribution, the maternity benefit, the housing contribution and foster parent remuneration and introducing new benefits relating to school supplies for children entering the first class of elementary school. The impact of this increase amounts to CZK 19.5 billion for 2007, of which CZK 15.2 billion relates to the increase in the parental contribution. In 2008, an increase in expenditures of CZK 23.4 billion is expected and CZK 26.2 billion in 2009.

#### **Introducing poverty relief assistance and cancellation of certain social care benefits**

A new system for poverty relief benefits will be introduced, which replaces the cancelled social need benefits. Social care benefits, which target disabled persons, will remain in tact. This legislative change should have a slightly positive impact on the budget in 2007 (reduction of expenditures by CZK 0.1 billion). However, it will be negative in future years (increase in expenditures of CZK 1.7 billion in 2008 and CZK 3.4 billion in 2009).

#### **Act on Social Services**

Upon adoption of the Act on Social Services, effective 1 January 2007, the structure and nature of state budget expenditures for activities financed or supported through this act will substantially change. A care allowance will be introduced, replacing the increase in pension for dependent individuals, and gradually over a three-year period, also the care allowance for next of kin as well as most of the funding for the costs of social service providers. The net impact of this act on the state budget's mandatory expenditures is estimated to be CZK 6.3 billion in 2007, CZK 5.4 billion in 2008 and CZK 4.4 billion in 2009.

#### **State's payment into the public health insurance system for non-income-earning individuals**

The assessment base is 25% of the average monthly wage defined as the product of the general assessment base and the coefficient for the purpose of pension insurance, which is set every year by way of a government decree. The state's payment per person and month in 2007 is CZK 680. An increase of CZK 9.7 billion in payments is expected in 2007, CZK 10.6 billion in 2008 and CZK 11 billion in 2009.

#### **Amendment to the Act on Pension Insurance**

Under the amendment to the Act on Pension Insurance, provisions on widows' pensions and miners' pensions were incorporated into the pension insurance system (effective 1 July 2006). The overall impact of this amendment is estimated to be CZK 0.6 billion in 2007 and CZK 0.5 billion in the following years.

**Table 6.2: Impact of the approved social legislation**

CZK billion	Year 2007	Year 2008	Year 2009
<b>Impact on revenues</b>			
Amendment to the Act on Social Security Contributions	0,0	-11,9	-22,7
New Act on Casualty Social Insurance (contributions)	0,0	5,9	5,2
<b>Total impact on social revenues</b>	<b>0,0</b>	<b>-6,0</b>	<b>-17,5</b>
<b>Impact on mandatory expenditures</b>			
New Act on Sickness Insurance	0,0	-2,6	-7,3
Government welfare benefits	19,5	23,4	26,2
Poverty relief benefits	12,0	13,7	15,6
Cancellation of certain social need benefits	-12,1	-12,0	-12,2
New Act on Social Services	8,8	9,3	9,7
Cancellation of the benefits for the "increase in pension for dependent individuals" and the care allowance for next of kin	-2,5	-3,9	-5,3
New Act on Casualty Social Insurance	0,0	4,0	4,2
Change in the assessment base for the state's payment into the public health insurance system	9,7	10,6	11,0
Amendment to the Act on Pension Insurance	0,6	0,5	0,5
Increase in the special benefits for security forces	0,2	0,3	0,3
<b>Total impact on social expenditures</b>	<b>36,2</b>	<b>43,3</b>	<b>42,7</b>
<b>Impact on the balance</b>			
Total impact on the balance	-36,2	-49,3	-60,2
<b>Total impact on the balance (in % of GDP)</b>	<b>-1,1</b>	<b>-1,3</b>	<b>-1,5</b>

Source: Ministry of Finance

### 6.3 Public Revenues

Total general government revenues vis-à-vis GDP will be in the range of 40% of GDP during the monitored period. The slow decline in the tax quota is due to the fact that total tax revenues register lower-than-unit-elasticity vis-à-vis GDP and due to measures geared in particular to reducing the high taxation of labour. On the other hand, an increase in indirect taxation will cause a rise in the share of general government revenues in GDP. Another significant factor will be the strengthening inflow of resources from EU funds for financing projects, particularly investment in infrastructure.

Approximately one fifth of tax revenues register low elasticity and, therefore, the relative share in the growing level of GDP is decreasing autonomously shrinking. This decline is only partially offset by tax revenues with growth higher than GDP (e.g. via progressive taxation of revenues), which as a result causes an autonomous decline in the overall compound tax quota.

The tax burden in terms of the compound tax quota will be in a range of 36.5% of GDP in 2005. The compound tax quota declined in 2006 by 0.5 of a percentage point to 35.5% and a further decline is expected in later years, up to 34.1% in 2009 (see Table 6.3).

Table 6.3: General government revenues

% of GDP	ESA code	Year 2005	Year 2006 (1)	Year 2007 (2)	Year 2008 (2)	Year 2009 (2)
<b>Components of revenues</b>						
<b>Total taxes</b>		20,9	20,4	20,0	19,9	19,4
<b>Taxes on production and imports</b>	<b>D.2</b>	11,6	11,3	11,2	10,9	10,5
<b>Current taxes on income, wealth etc.</b>	<b>D.5</b>	9,3	9,0	8,8	9,0	8,9
<b>Capital taxes</b>	<b>D.91</b>	0,0	0,0	0,0	0,0	0,0
<b>Social contributions</b>	<b>D.61</b>	15,1	15,1	15,1	14,8	14,7
<b>Property income</b>	<b>D.4</b>	0,7	0,8	0,8	0,7	0,7
<b>Other</b>		3,7	3,7	4,1	4,9	5,5
<b>Total revenue</b>	<b>TR</b>	40,4	39,9	39,9	40,4	40,3
<b>p.m.: Tax burden</b>		36,0	35,5	35,1	34,7	34,1

(1) Estimate

(2) Outlook

Source: Ministry of Finance (2005 calculation of the Ministry of Finance from Czech Statistical Office sources)

The tax measures as a part of the ongoing fiscal restructuring are geared to promoting economic growth and employment. The trajectory for the shift of the tax burden from direct taxes to indirect taxes described in the last CP also continued during 2006. The goal is to reduce the distortion effect of direct taxes on economic activity.

The effective taxation of the incomes of legal entities was reduced mainly due to a gradual decline in the marginal rate of corporate income tax from 28% in 2004 to 24% in 2006. This trend also supported the possibility of reducing the tax base for investment in research and development introduced in 2005.

The taxation of labour was reduced in particular by changes in personal income tax. The joint taxation of spouses with children and tax bonuses for unsupported children were introduced. From 1 January 2006, there was another decline in the effective taxation of personal incomes. This involved reducing the two lowest marginal rate categories from 15% to 12% and from 20% to 19%, valorising the first tax bracket and replacing the standard tax allowances with tax credits. These changes also motivate low-income groups to work and increase the flexibility of the labour market.

The sickness insurance reform, effective from 1 January 2007, should also contribute to the decline in labour taxation. This reform includes a reduction in the rate of sickness insurance contributions paid by employers. In view of the strong negative impact on the state budget deficit, however, this change should be postponed in 2007 as a part of the draft state budget. Reductions in this rate will take place during 2008 and 2009 (see Box 6.1 and Table 6.2).

The prepared environmental tax reform, which should come into effect in 2008, will bring additional changes geared to the restructuring of the tax burden. The reform concept assumes fiscal neutrality. The specific parameters of the prepared changes, however, have not yet been set, and the impact of the reform is, therefore, not included in the projections for general government revenues.

In the area of excise taxes, the draft state budget for 2007 counts on an increase in the excise tax rates for tobacco products with respect to meeting the timeframe agreed for complying

with the minimum rates valid in the EU by 2007. Additional increases will occur in 2008 in accordance with the Accession Agreement.

### Box 6.2: Changes in taxation

#### **Reduction in corporate income tax**

The corporate income tax rate for 2005 was reduced to 26% (from 28% in 2004). The tax rate was cut again in 2006 to 24%. Assuming a 5% increase in the tax base, the impact of the tax rate cut on general government revenues is estimated to be a decline of CZK 17.6 billion in 2007, CZK 16.8 billion in 2008 and CZK 15.8 billion in 2009.

#### **Cut in personal income tax rates**

Important revenue related changes to the tax system coming into effect during the past two years include the cut in the tax rates for low- and medium-income groups, extending the tax bracket for the low-income group, replacing the tax allowances with tax credits and the joint taxation of spouses. These tax changes were targeted measures for increasing the disposable income of low- and medium-income earners and also increasing the level of the Czech tax system's vertical equity. In contrast to cutting tax rates, extending the tax bracket and introducing the joint taxation of spouses, the introduction of bonuses for unsupported children and replacing the tax allowances with tax credits had no substantial effect from the standpoint of the impact on the general government or increasing disposable income. The overall impact between 2007 and 2009 will be reflected on a concrete level as a reduction in general government revenues of CZK 23.7 billion in 2007, CZK 23.4 billion in 2008 and CZK 23 billion in 2009.

#### **Introducing tax allowances for research and development**

The newly introduced tax allowances permitted expenditures for research and development amounting to CZK 4.9 billion, according to preliminary and incomplete figures. From the standpoint of the net accrual approach used in the ESA 95 methodology, the estimated impact of this tax allowance on general government revenues from 2007 to 2009, taking into account a corporate income tax rate of 26% for 2005 and 24% for 2007 to 2009 and a 10% increase for the entries, is as follows: CZK 1.4 billion in 2007, CZK 1.6 billion in 2008 and CZK 1.7 billion in 2009.

#### **Environmental tax reform**

Estimates of the impact of introducing environmental taxes have not yet been included in the quantitative scenario because no final decision has yet been made on the rates and extent of the exemptions or on tax allowances as key parameters for calculating the revenue and setting compensation.

#### **Increasing excise taxes for tobacco products**

The Czech Republic is obliged to comply with the minimum required EU rates by 2008. In 2007, a rise in the rates should increase tax collection by CZK 10.4 billion against 2006. In 2008, an additional phase of rate increases should follow so that the Czech Republic can meet the EU requirements. The excise tax rates on tobacco products for 2008 have not yet been set, and therefore, the impact on the budget cannot be determined. It can be said, however, that this change will no longer be very significant. The financial impact of increasing excise taxes for tobacco products on general government revenues is estimated to be CZK 10.4 billion per annum during the period 2007–2009.

Completion of the Czech National Development Plan 2007–2013 in February 2006 was decisive for the drawdown of financial resources from the structural funds and the Cohesion Fund in the new programme period 2007–2013. This became the basis for drafting the Czech National Strategic Reference Framework for the period 2007–2013 as a master document for all operational programmes needed for drawing down resources from the structural funds and the Cohesion Fund. The strategic framework combines the priorities identified in the National Development Plan with the EU's objectives in the area of economic and social cohesion policy during the period 2007–2013. The resources of the structural funds and the Cohesion

## 6 Quality of Public Finances – Revenues and Expenditures

Fund are being gradually integrated into the national budgetary process. This was partially implemented up to 1 January 2006, and full integration should take place by 1 January 2007.

An overview of the main changes in the area of taxation and an assessment of their expected impact are given in Box 6.2 and Table 6.4.

**Table 6.4: The impact of tax changes on general government revenues<sup>(a)</sup>**

% of GDP	Year	Year	Year
	2007	2008	2009
<b>Taxes, total</b>	<b>-0,9</b>	<b>-0,8</b>	<b>-0,8</b>
<i>of which: VAT</i>	<i>0,0</i>	<i>0,0</i>	<i>0,0</i>
<i>Excises</i>	<i>0,3</i>	<i>0,3</i>	<i>0,3</i>
<i>CIT</i>	<i>-0,5</i>	<i>-0,5</i>	<i>-0,4</i>
<i>PIT</i>	<i>-0,7</i>	<i>-0,6</i>	<i>-0,6</i>

(a) The impact of approved changes as compared with the state of the tax system at the end of 2004

Source: Ministry of Finance