

8 The Institutional Framework for Fiscal Policy

The concept of the 2003 public finance reform laid the foundation for increasing the quality of the institutional framework of public finances. The individual steps of this reform are now taking place¹⁹. In addition, the new measures geared to the recently identified challenges for overall public finance management have been approved.

The principal objectives of the reform were identified as follows:

Table 8.1: Objectives and measures of the 2003 Public Budget Reform

Objectives	Measures
1. Improving fiscal discipline and the medium-term outlook	- Fiscal targeting - Medium-term expenditure frameworks
2. Strengthening the effectiveness of public expenditures	- Reserve funds - Programme budgeting
3. Increasing the transparency of public finances	- Integration of extra-budgetary institutions - Fiscal targeting

8.1 Implementation of the Public Finance Reform

Medium-term expenditure frameworks

Fiscal targeting and the binding medium-term nominal expenditure frameworks have become a standard part of the budgetary process promoting the medium-term focus of budget policy. As a result, the budgetary process has become a consistent two-phase process. The decision-making on the aggregate level has been separated from the decision-making on individual budgetary line items or programmes. Meeting the aggregate frameworks should contribute to the anti-cyclical effects of fiscal policy and should increase the manoeuvring space for expenditure restructuring needed for the promotion of sustainable economic growth.

On a practical level, the adopted principles have so far only been partially upheld and the assessment of their effectiveness has been mixed. Introducing these principles along with favourable economic development and certain expenditure savings has contributed to the positive results of general government finances. However, problems do exist. Considering that the significant scope of additional general government revenues exceeded the estimates on which the expenditure framework settings were based, only a part of these additional revenues were used to reduce the deficit. The remainder was used to finance the additional expenditures, which caused the expenditure frameworks to be exceeded. However, sticking to the expenditure frameworks with substantially higher-than-expected tax revenues would have had a significantly more restrictive impact than was originally intended.

A challenge for intensifying the effects of the medium-term expenditure frameworks remains the strengthening of their accountability and the possible introduction of sanction procedures setting the steps in the event that the expenditure limits for the state budget headings are not met.

¹⁹ Described in detail in 2004 programmes

Integration of the state extra-budgetary institutions

The National Property Fund was terminated on 1 January 2006, and its activities and assets were transferred to the Ministry of Finance. Preparations have also continued with the termination of the Czech Consolidation Agency, which manages and trades non-performing assets associated in particular with transformation of the banking sector. The agency will be terminated on 31 December 2007, and the Ministry of Finance will become its successor. The Land Fund, which is entrusted with the privatisation of agricultural land, should be terminated on 31 December 2009.

Reserve funds

A relatively large amount of unspent funds has been transferred to the reserve funds since their creation, and the volume of future carryovers is very difficult to estimate. In addition, reserve funds allow organisational units to increase expenditures above the approved budgetary allocation, which complicates meeting the fiscal targets. In fact, this limits the government's capacity to pursue a stabilising fiscal policy and worsens the pre-conditions for fiscal targeting.

In this respect, the government began regulating the volume of carryovers in 2006 with the goal of stabilising the volume to the level existing at year-end 2005. In 2007, resources from the reserve funds may only be used with prior government approval²⁰ and with respect to the set fiscal targets and fiscal policy stance.

Experience with fiscal targeting and introducing unlimited carryovers of unspent funds to reserves has revealed the deficiencies in the budgetary process. A change in the methods of budgeting the line items and programmes, among others, should help eliminate these deficiencies.

Programme budgeting

Although the budgetary process is generally based on a top-down approach, method of incremental budgeting still exists at lower levels relating to past "historical bases". This, however, has a number of drawbacks, especially the potential risk of maintaining bad decisions from the past and not being able to make *ex-post* assessments of the effectiveness of public expenditures.

The main instrument for eliminating these deficiencies should be programme budgeting. In order to successfully implement such an instrument, a common methodology for specifying the requirements in the form of programme documents must be introduced (objectives, criteria for assessing effectiveness, monitoring indicators, etc.).

²⁰ The restrictions for 2006 and 2007 do not relate to the funds earmarked for financing flood damages, supplementary financing for European projects and funds earmarked for financing Common Agricultural Policy.

8.2 New Challenges

Increasing the absorption of European funds

The main fiscal challenge is to increase absorption and to ensure sufficient space in public budgets for co-financing substantially larger volumes of funds that the Czech Republic will have at its disposal as a part of the EU financial perspectives 2007–2013. This will also require institutional changes.

On 1 January 2007, the transfers from the structural funds and the Cohesion Fund will be completely integrated into the national budgetary process which will simplify and speed up the system for the financial flow of EU funds to end users.