6 Quality of Public Finances – Revenues and Expenditures

6.1 The Government's Strategy

Successful fiscal consolidation is a condition for a stable economic environment, and an appropriate structure of public revenues and expenditures can contribute to dynamic economic growth. Therefore, in addition to expenditure savings, fiscal consolidation relies on a change in the structure of tax revenues and expenditure programmes and a change in the social legislation with the goal of promoting a competitive economic environment and increasing motivation to actively participate on the labour market.

The government is working towards strengthening expenditures in the areas covered by the Economic Growth Strategy and the National Reform Programme. In addition, it aims to ensure that expenditures for the government's programme priorities do not exceed the trajectory of the decline in the deficit and that they are not in conflict with the medium-term expenditure frameworks. Resources from the structural funds and the Cohesion Fund will also be used to a large degree to support priorities. The volume of these funds will increase for the new member states with respect to the new financial perspective. The promotion of research and development is even strengthened from the income side of the state budget through legislative changes relating to income tax.

6.2 Public Expenditures

The positive developments in the area of tax revenues have diluted the need for expenditure savings. Thanks to acceleration of economic growth and slowed expenditure growth, the fiscal framework assumes a decline in general government expenditures vis-à-vis GDP. In contrast to the level expected at the end of 2005, the share of government expenditures in GDP will be reduced by about two percentage points. The anticipated rapid launch of projects co-financed from the structural funds and the Cohesion Fund will work against the decline in expenditures. This is reflected in higher gross fixed capital formation and in part current ordinary expenditures. The expected growth of interest rates and a higher government debt level are factors that will work in the direction of expenditure growth for debt service.

Table 6.1: General government expenditures

% of GDP	ESA code	Year 2004	Year 2005 (1)	Year 2006 (1)	Year 2007 (2)	Year 2008 (2)
Components of expenditures						
Collective consumption	P.32	11,3	11,2	11,0	10,6	10,2
Total social transfers	D.62+D.63	23,2	23,1	22,7	22,1	21,6
Social transfers in kind	D.63	11,3	11,3	11,0	10,7	10,5
Social transfers other than in kind	D.62	11,9	11,8	11,7	11,4	11,2
Interest expenditure	EDP D.41	1,3	1,3	1,3	1,3	1,5
Subsidies	D.3	2,2	2,3	2,1	2,0	2,0
Gross fixed capital formation	P.51	5,0	5,2	5,2	5,3	6,1
Other		1,6	2,9	1,7	1,7	2,2
Total expenditures	TE	44,7	45,9	44,0	43,1	43,6
p.m.: Compensation of employees	D.1	8,1	8,0	7,8	7,6	7,3

(1) Estimate
(2) Trend values or period averages

Source: Ministry of Finance

The effect of the austerity measures described in detail in the November 2004 programme has to a large extent already died out. These measures (especially reducing sickness benefits, cancelling the transport benefit, reducing budget heading expenditures, etc.) have lowered expenditures levels in 2004. The measures focusing on stabilisation of the pension system and a gradual reduction in the number of general government employees have a longer-term effect. Reducing the number of employees accompanied by moderate average wage growth (4.5% to 5.0% annually) contribute to reducing compensation to employees by 0.7 percentage points, and in the end, will reduce the expenditures for collective and individual consumption.

Favourable economic development creates assumptions for slower social benefit growth. Therefore, a decline vis-à-vis GDP is expected. Measures strengthening the effectiveness of the social benefits system were adopted in 2004. The austerity measures proposed by the Minister of Finance in the previous Convergence Programme contained proposals for a further reduction in social benefits, but these measures were not implemented. A complex set of social legislation was submitted to the Chamber of Deputies this year (see Section 4.6). The effects of this legislation have not yet been reflected in the fiscal framework, and other important changes could develop during deliberation. Although this legislation increases motivation for more actively resolving the social situation, its anticipated impact on the general government balance is negative. Therefore, adoption of this legislation will require savings in other areas.

Reducing the majority of expenditure entries vis-à-vis GDP created space for increasing gross fixed capital formation. In an international context, this has already reached a high level in the general government, however, with access to the structural funds and the Cohesion Fund, space has been created for an additional increase. Particularly in 2008, gross fixed capital formation will increase to as much as 6.1% of GDP[18] at which time the Czech Republic will gain access to a substantially higher volume of EU funds as a part of the new Financial Perspective. This should substantially speed up the process of developing a transport and ecological infrastructure.

[18] *We expect the Czech Republic to obtain a maximum aggregate allocation of ca 3.6% of GDP per annum.*

6.3 Public Revenues

Restructuring of the revenue side has been taking place now for two years. Tax measures are geared to promoting economic growth and employment. The shift of the tax burden from direct taxes to indirect taxes also continues. The goal is to reduce the distortion effect of direct taxes on economic activity, which is stronger than that of indirect taxes.

Acceleration of economic growth and tax changes implemented during 2004 and 2005 have triggered significant growth in general government revenues above the budgetary plans. From 2005 to 2008, however, we anticipate a decline in the tax quota by about 1.4 percentage points. This is prompted by the planned reduction in income taxes (by ca 0.7 percentage points) and the effect of the GDP growth composition. The dynamics of private and government consumption will stall significantly behind the GDP growth rate. Consequently, VAT and excise tax revenues will fall vis-à-vis GDP.

Total revenues are practically unchanged during the monitored period. This is caused by the increased inflow of EU funds, which is expected in 2007 and especially in 2008 upon adoption of the new Financial Perspective due to a higher drawdown of resources from the structural funds and the Cohesion Fund. Higher drawdown by the general government is adequately reflected on the expenditures side as well.

Table 6.2: General government revenues

% of GDP	ESA code	Year 2004	Year 2005 (1)	Year 2006 (1)	Year 2007 (2)	Year 2008 (2)
Components of revenues						
Total taxes		21,4	21,2	20,4	19,9	20,0
Taxes on production and imports	**D.2**	11,9	11,8	11,9	11,6	11,3
Current taxes on income, wealth etc.	**D.5**	9,5	9,3	8,5	8,3	8,6
Capital taxes	**D.91**	0,0	0,0	0,0	0,0	0,0
Social contributions	**D.61**	15,3	15,2	15,2	15,1	15,0
Property income	**D.4**	0,8	0,5	0,5	0,5	0,4
Other		4,2	4,1	4,1	4,4	5,5
Total revenue	**TR**	41,6	41,1	40,2	39,8	40,9
p.m.: Tax burden		36,7	36,4	35,7	35,0	34,9

(1) Estimate
(2) Trend values or period averages

Source: Ministry of Finance

The tax changes in the first and second stages of the public finance reform presented in the previous Convergence Programme were adopted, though, with several exceptions (e.g. a reduced VAT rate for hotel services and VAT exemption for language schools). These changes will be positively reflected in tax revenues over a period of time.

As for personal income tax, a reduction in the taxation for low- and medium-income groups can be expected starting in 2006 as well as other measures which should significantly increase motivation to actively participate on the labour market (see Box 2.2). The result should increase the disposable income from labour and increase vertical tax equality.

Certain changes have been proposed for corporate income taxes as well and include, for example, cancelling the tax exemption for interest revenues on mortgage bonds, introducing a limited discount on taxes when acquiring cash registers or when tightening conditions for the creation of provisions at banks. The option of deducting 100% of the expenditures invested in research and development from the tax base was also introduced to promote competitiveness.

A decline in revenues can also be expected with VAT. This relates to the adjustment of certain changes adopted in the public finance reform, such as keeping hotel services in the reduced rate category (originally shifted to the standard rate) and VAT exemption for language schools.

In the area of excise taxes, the excise tax rates for tobacco products were adjusted in respect to the Czech Republic complying with the time schedule agreed with the European Union. According to this schedule, gradual steps should be taken up to 2007 to reach the minimum rates valid in the European Union. The amendment to the Excise Tax Act proposes an excise tax rate set over two gradual stages. This consists of a change in the excise tax rates for tobacco products on the effective date of the proposed amendment as well as a change starting on 1 April 2006.

Table 6.3: The impact of tax changes on public budgets (1)

% of GDP	Year 2006	Year 2007	Year 2008
Taxes, total	**-0,7**	**-0,7**	**-0,6**
of which: VAT	*-0,2*	*-0,2*	*-0,1*
Excises	*0,2*	*0,2*	*0,2*
CIT	*-0,1*	*-0,1*	*-0,1*
PIT	*-0,7*	*-0,6*	*-0,6*

(1) The impact is expressed on an accrual basis and is given as a deviation from autonomous development.

Source: Ministry of Finance