3 General Government Deficit and Debt

3.1 Current Development of Public Finances

The trend of improvement in general government finances ended with 2007. The general government balance in 2008 reached –2.1% of GDP, which represents a year-on-year worsening by 1.4 percentage points. This figure is 0.9 percentage points poorer in comparison with the assumptions from last year's CP update.

Worsening of general government finances in 2008 is primarily due to the economy's development in the second half of that year, and measures approved in 2007 aimed at sustaining public budgets were not sufficient to reverse the effects of this economic development. General government revenues increased by only 1.8% year-on-year mainly due to a very slight increase in tax revenues that represent a dominant share in total revenues.

The reform package approved in 2007 was reflected on the expenditure side essentially the same as on the revenue side. In particular, the growth rate of social transfers[6] decreased more significantly while, on the other hand, the growth in government investments accelerated. In 2008, therefore, a fairly favourable regrouping of expenditure priorities occurred. Unlike the revenue side, the economic crisis had yet no major impacts on the expenditure side of the government sector in the given year.

With the exception of excise taxes, revenue from all major taxes and social contributions declined in 2009. In addition to the dominant influence of the economic crisis, the adopted stimulus measures and reform measures from 2007 also contributed to this development. On the revenue side, more significant growth is expected in non-tax revenues, particularly due to the increase in general government investment grants received from abroad. These especially include EU payments for projects that it supports. This revenue is also reflected on the expenditure side and only affects the general government balance in the amount of Czech co-financing. The general government balance in this year is positively influenced also by savings of revenues from the sale of Assigned Amount Units of CO_2 in the amount of 0.3% of GDP.

General government expenditures in 2009 maintained their growth dynamics. Final consumption of the government actually recorded an acceleration in its growth rate in comparison with the previous period despite certain austerity measures from early 2009. The reason is a rise in social benefits in kind that constitute mainly general government expenditures on health care and stimulus measures consisting in an increase in state sector wages adopted in connection with the crisis. Another significant factor of total expenditure growth is interest paid.

In total, the adopted anti-crisis measures reach approximately 2% of GDP. They focused primarily on reducing the tax burden on businesses and individuals. On the expenditures side, to a lesser extent, they were directed to supporting investments into infrastructure and research, into export, which was affected severely by the crisis, and into purchasing power demand through a one-time increase of civil servants' salaries. As mentioned above, some

[6] The adopted legislative measures contained in Act No. 261/2007 Coll., On Stabilisation of Public Budgets, were evident in 2008–2010 in the overall reduction of expenditures on social benefits by CZK 90 billion.

planned measures from 2007 were subsequently fully or at least partly used to counter the crisis. These included especially a reduction in the corporate income tax rate (accompanied by deferral of tax advances), a transformation of the planned reduction in personal income tax rates into a reduction of the social security rate paid by employees (which has a more uniform impact on taxpayers in contrast to the originally planned change and thereby increases the purchasing demand of low-income groups as well), and finally maintenance of the planned amount of investments into transport infrastructure (although plans for their limitation have already been prepared).

Table 3.1: Anti crisis measures for 2009

Measures	2009 ESA 95 (bn CZK)		
	Rev	Exp	Balance
I. Tax measures			
1 Changes in CIT	-16,0	0,0	-16,0
2 Changes in VAT	-2,5	0,0	-2,5
3 Changes in social security contributions	-36,4	0,0	-36,4
Total I	-54,9	0,0	-54,9
II. Other measures			
1 Salaries and social security expenditures	0,4	2,9	-2,5
2 R&D and infrastructure investments	0,0	9,3	-9,3
3 Support of SME´s	0,0	4,5	-4,5
4 EU funds and state funds	0,0	5,1	-5,1
5 Reserve funds integration	0,0	-1,5	1,5
Total II	0,4	20,2	-19,8
Total I+II	-54,5	20,2	-74,7

Source: Outlook

After good results in previous years, the local government sub-sector and social security funds also fell into deficit.

The general government balance should be around –6.6% of GDP for 2009, which is some 5.0 percentage points worse than figured in the assumption in last year's CP update. The deficit will probably deepen by 4.5 percentage points compared to 2008. Several factors contributed to this result. These include, in particular, the strong impacts of the economic crisis on fiscal positions, including the strong effects of automatic stabilisers and the anti-cyclical nature of Czech fiscal rules, which also increase the deficit in times of strong economic downturn, as well as the government stimulus package in support of the economy.

3.2 The Medium-Term Fiscal Outlook

The distinctive worsening in its fiscal position led the government to quickly reorient fiscal policy from stimulative, anti-crisis measures to the first consolidation steps prepared by the government in preparing the budget for 2010.

The budget for 2010

The state budget for 2010 emerges from the approved expenditure framework, which should ensure achieving a general government budget balance of around –5.3% of GDP. The approved expenditure framework for 2010 already reflects the government's efforts to bring the excessive and, in the long term unsustainable general government deficits under control and is thus lower, if only for the given year marginally, as compared to the original expenditure framework. Furthermore, the government is planning to adopt such measures within its power, especially that of fixing expenditures under the budget chapters, to ensure the deficit is kept within the stated amount.

Aware of the problems in public budgets, the economic inefficiency of excessive indebtedness potentially leading to problems with funding the debt interest itself, and the expected gradual economic recovery, the Czech government has pushed through Parliament in connection with preparation of the 2010 budget proposal measures to reduce the general government deficit. The Czech Republic thus will be one of the first countries to begin consolidating its public finances. Compared to 2009, and in the context of an uncertain future development, the government deficit thus will significantly decrease by 1.3 percentage points.

The vast majority of economic measures is aimed at the revenue side of public budgets; and only a smaller part will lead to expenditure reductions. Moreover, the impact of the expenditure measures is designed only for 2010. This imbalance can create risks for the future as revenues are generally more volatile than expenditures.

Another factor that may affect the general government balance in coming years are revenues and expenditures associated with the sale of Assigned Amount Units of CO_2. The government decided to use all of these additional funds for environmental projects. The general government balance for the period of implementing these revenues and expenditures thus will not be affected, but revenues and expenditures will not be in harmony over individual years and these individual balances will thus be affected.

Compared to the past, it is no longer necessary to consider the risk of increasing general government deficits due to an unexpected increase in expenditures as a result of integration of reserve funds. Resources from reserve funds that were not designated for pre-financing of projects co-financed from EU funds were used in early 2009 to finance the rapidly increasing deficit and not to finance new projects, as originally planned.

Table 3.2: Government balance by sub-sector

% of GDP	ESA code	Year 2008	Year 2009 (1)	Year 2010 (2)	Year 2011 (2)	Year 2012 (2)
Net lending (+)/borrowing (-) (EDP B.9) by sub-sectors						
General government	S.13	-2,1	-6,6	-5,3	-4,8	-4,2
Central government	S.1311	-2,4	-5,8	-5,2	-4,8	-4,2
Local government	S.1313	0,1	-0,6	-0,1	-0,1	0,0
Social security funds	S.1314	0,3	-0,2	0,0	0,0	0,0

(1) Notifications (October 2009)
(2) Outlook

Source: Czech Statistical Office (2008), Ministry of Finance.

Outlook for 2011 and 2012

Aware of the commitments of the Czech Republic as an EU Member State, the government, despite its time-limited mandate, has proposed in this Convergence Programme the continuation of the consolidation strategy beyond 2010. In contrast to 2010, greater attention will be placed on the expenditures side of public budgets. The largest measure in terms of volume is the reduction of expenditures under the budget chapters. Furthermore, reduction of mandatory expenditures is proposed. Both are measured against the no-policy-change scenario for 2011 and 2012.

On the revenues side, a permanent increase in ceilings for social security to six times the average wage, maintaining sickness insurance in its current form and the introduction of a 31% personal income tax rate on income exceeding social security ceilings are being considered.

These measures combined should ensure reduction of the general government deficit to 4.8% of GDP in 2011 and 4.2% of GDP in 2012.

3.3 The Structural Balance and the Fiscal Stance

According to current data, the Czech economy at the turn of 2008 and 2009 was in a recession phase. In 2009, GDP fell well below its potential level, and thus a positive output gap was overturned into negative values. Considering the slow economic recovery, we expect the negative output gap to deepen also in 2010 and to see gradual and only very slight improvement in 2011 and 2012.

As a result of the adverse macroeconomic conditions and the adoption of stimulus measures, the nominal deficit as a proportion of GDP for 2009 will increase. The structural balance in 2009 will reach a level of –5.5% of GDP and between 2010 and 2012, as a result of adopted and proposed consolidation measures, will gradually improve to –2.6% of GDP. In the item “One-off and other temporary measures”, one-off revenues from the sale of Assigned Amount Units of CO_2 and the related one-off expenditures are taken into account in 2009–2012.

The fiscal effort, defined as the year-on-year change in the structural balance, did not develop well in 2008 and 2009. In 2009, the negative impacts of stimulus measures adopted by the Czech Republic in response to and in accordance with the European Economic Recovery Plan were evident here. In 2010, the adopted consolidation measures will result in a positive turnover and thus in a positive and relatively high fiscal effort. Positive fiscal effort in 2011 and 2012 thus corresponds with the intention of the government to gradually further consolidate Czech public finances.

Table 3.3: Structural balance [(a)]

% of GDP	ESA code	Year 2008	Year 2009 (1)	Year 2010 (2)	Year 2011 (2)	Year 2012 (2)
1. Real GDP growth (%)		2,5	-4,0	1,3	2,6	3,8
2. Net lending of general government	**EDP B.9**	-2,1	-6,6	-5,3	-4,8	-4,2
3. Interest expenditure	**EDP D.41**	1,1	1,1	1,7	2,0	2,1
4. One-off and other temporary measures		-0,1	0,2	-0,1	-0,1	-0,3
5. Potential GDP growth (%)		3,6	3,1	2,5	2,5	3,0
contributions:						
- total factor productivity		2,2	1,8	1,6	1,8	2,2
- labour		0,4	0,5	0,3	0,1	0,1
- capital		1,0	0,8	0,6	0,6	0,7
6. Output gap		2,5	-4,6	-5,6	-5,5	-4,8
7. Cyclical budgetary component		0,7	-1,2	-1,6	-1,6	-1,3
8. Cyclically-adjusted balance (2 – 7)		-2,8	-5,3	-3,7	-3,3	-2,9
9. Cyclically-adjusted primary balance (8 + 3)		-1,7	-4,2	-1,9	-1,2	-0,8
10. Structural balance (8 – 4)		-2,7	-5,5	-3,6	-3,2	-2,6

(a) The data in rows 5 to 10 are based on the current estimates of the Ministry of Finance.
(1) Estimate.
(2) Outlook.

Source: Ministry of Finance.

3.4 Government Debt

The expected scenario for public finances development indicates that the general government debt will increase in the overall outlook horizon from 30% of GDP in 2008 to 42.0% of GDP in 2012. The main factor for the rapid growth in government debt is the amount of the central government deficits. However, the general government debt should increase more slowly than would correspond to a simple accumulation of deficits. These are also funded partially from the accumulated financial assets from 2009 onwards.

Table 3.4: Government debt by sub-sector

% of GDP	ESA code	Year 2008	Year 2009 (1)	Year 2010 (2)	Year 2011 (2)	Year 2012 (2)
		Gross debt by sub-sectors				
General government	**S.13**	**30,0**	**35,2**	**38,6**	**40,8**	**42,0**
Central government	**S.1311**	**27,5**	**32,6**	**36,0**	**38,2**	**39,6**
Local government	**S.1313**	**2,5**	**2,6**	**2,7**	**2,6**	**2,5**
Social security funds	**S.1314**	**0,0**	**0,0**	**0,0**	**0,0**	**0,0**

(1) Notifications (October 2009).
(2) Outlook.

Sources: Czech Statistical Office (2008), Ministry of Finance.

This scenario does not take into account any new privatisation actions. In the case of executing some further privatisation projects and the use of privatisation revenues to finance government expenditures, then the proportion of government debt to GDP would grow more slowly compared to the outlook. The project of the state treasury, currently under preparation, will also contribute to non-debt financing of the central government deficit (see Chapter 7).

Table 3.5: Government debt and related indicators

% of GDP	Year 2008	Year 2009 (1)	Year 2010 (2)	Year 2011 (2)	Year 2012 (2)
Gross debt	30,0	35,2	38,6	40,8	42,0
Change in gross debt share	1,0	5,2	3,4	2,3	1,2
Contributions to change in gross debt					
Primary balance	1,0	5,4	3,5	2,8	2,1
Interest expenditure	1,1	1,1	1,7	2,0	2,1
Nominal GDP growth	-1,2	0,3	-0,7	-1,3	-2,1
Stock-flow adjustment	0,1	-1,6	-1,2	-1,2	-0,9
- Difference between cash and accruals	-1,3	-0,5	-0,5	-0,3	-0,2
- Net accumulation of financial assets	1,3	-1,1	-0,7	-0,7	-0,6
of which: Privatisation proceeds (3)	0,6	0,0	0,0	0,0	0,0
- Valuation effects and other	0,1	0,0	0,0	0,0	0,0
p.m. implicit interest rate on debt	3,6	3,3	4,5	5,0	5,0

(1) Notifications (October 2009).
(2) Outlook.
(3) Privatisation alone has no impact on the amount of the debt. However, cash revenues from privatisation are one of the potential sources of non-debt financing for the deficit.

Source: Ministry of Finance.

The debt strategy and stability of the risk structure of government debt

An important factor in the stability of public finances and the national financial system is a sustainable risk structure of state debt, which accounts for over 90% of the total general government debt. When designing the state's medium-term debt management and issuance strategy, great attention is devoted to refinancing and market risks. These present the most significant sources of uncertainty for government financing and their stabilisation appears to be particularly significant during a period of considerable volatility on international financial markets and investor uncertainty.

The long-term target of the strategy was to reduce the proportion of the short-term state debt (i.e. debt payable within one year) from the 69% in 2000 to below a threshold of 20%. This target value was achieved for the first time in 2006 and has been a key stabilising element in subsequent years in financing the central government's borrowing needs and in planning issuance activity on domestic and foreign markets. This criterion was maintained in 2009.

Table 3.6: Refinancing of the state debt

	Year 2006	Year 2007	Year 2008	Year 2009 (1)	Year 2010 (2)	Year 2011 (2)	Year 2012 (2)
Average maturity (years)	**6,2**	**6,4**	**6,6**	**6,4**	**6,0**	**6,3**	**6,3**
Debt due within 1 year (% of debt)	**17,1**	**18,7**	**17,7**	**14,3**	**15,0**	**15,0**	**15,0**
Financing reserve/debt due within 1 year (%)	**1,9**	**7,3**	**44,1**	**39,6**	**42,7**	**39,8**	**37,5**

(1) Forecast
(2) Strategic plan

The stable refinancing structure is also confirmed by the average maturity of state debt. This indicator ranged from 6 to 7 years, and in 2009 its value also remained above the threshold of 6 years with no significant reduction. For 2010, the target range for the average maturity of state debt was set at 5.5–7 years.

As at the end of 2009, the structure of state debt in terms of interest paid on debt instruments has generated an exposure to a change in interest rates on a one-year horizon of about 30% of the state debt (debt with interest rate refixing up to 1 year). The interest-rate exposure expressed in this way has hovered around this value since 2004. In terms of the debt portfolio's stability, this constitutes a threshold that can be regarded as relatively safe and comparable also with the international practice of developed countries.

Table 3.7: The state debt's interest

%	Year 2006	Year 2007	Year 2008	Year 2009 (1)	Year 2010 (2)	Year 2011 (2)	Year 2012 (2)
1. Fixed interest long-term debt due within 1 year	5,4	9,0	9,8	7,0	7,6	4,3	6,7
2. Variable interest long-term debt	4,3	4,1	7,3	13,1	13,0	14,0	11,6
3. Monetary instruments	11,5	9,2	7,9	7,2	6,3	6,3	6,3
4. Effect of derivative operations	4,2	3,7	3,4	3,0	3,1	5,4	5,4
5. Debt with interest fixation within 1 year (1+2+3+4)	25,4	26,0	28,4	30,3	30,0	30,0	30,0

(1) Forecast
(2) Strategic plan

In terms of the interest-rate structure, the proportion of variable interest rate long-term instruments grew in 2008 and 2009. This led to an increase in the overall interest rate exposure. At the same time, however, the share of money market instruments in financing long-term debt was reduced. The effect of derivative transactions on the interest rate exposure relates to operations hedging the currency risk in foreign issues.

It can 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 by approximately CZK 3.5 billion in the 2010 horizon.

3.5 The Budgetary Impact of Major Reforms

General government finances during the CP horizon are influenced by a set of measures aimed at stabilising public finances that were approved in 2007 and, for the most part, became effective as from 1 January 2008. Furthermore, they are influenced by the stimulus measures associated with the European Economic Recovery Plan, by the austerity measures approved during the second half of 2009, and finally by the measures proposed by the government for 2011 and 2012.

The impacts of the first two groups of measures were accounted for and enumerated already in previous CP updates and supplements to last year's CP update. Estimates of the impacts of these two groups of measures have not yet been revised. Certain items among the government revenues and expenditures are developing differently from the original assumptions. The differences, however, are not of such an extent that it would be possible, particularly in the current turbulent period, to determine with certainty whether this results from an inaccurate estimate of impacts or is a distinctly autonomous development owing to lower-than-expected economic growth, higher-than-expected inflation, and other factors.

The approved austerity measures were incorporated into the current CP scenario on the revenues side in increasing taxes and social contributions and on the expenditures side particularly in temporary freezing of pensions, cancellation of administrative positions in the general government and reduction of certain social benefits. The measures proposed by the government for 2011 and 2012 also were incorporated into the CP.

Table 3.5 summarises the incremental effects[7] of the fiscally important economic policy measures approved by Parliament that change the fiscal outlook compared to last year's CP update. The nature of certain measures, in particular their temporariness, the suspension of originally envisaged measures and the cancellation of other only temporary measures result in problems with their intuitive depiction. The interpretation of impacts presented in Table 3.5 and in Chapter 5 thus should be given increased attention.

For example, the increase in revenues from insurance premiums in 2010 consists of an increase in ceilings for contributions to social security and health insurance[8], cancellation of the temporary credit on social security contributions paid by employers, and postponement of the reduction in the sickness insurance rate. With the exception of an increase in the ceiling for health insurance, the measures are only for 2010, and thus in the incremental depiction the measures effective only in 2010 must be recorded in the following year with the opposite sign[9].

[7] By contrast, the effects in Chapter 5 are enumerated in comparison with the no-policy-change scenario and are therefore cumulative.

[8] The ceiling for social security is increased only for 2010; the ceiling for health insurance is increased indefinitely.

[9] The temporary nature of the planned effectiveness of the credit on social security contribution, which was approved for 2009 and 2010, and the year-long postponement of the effectiveness of the reduction in the sickness insurance rate, however, imply that the no-policy-change scenario for 2011 already has taken into account lower revenues due to the reduction in the health insurance rate and higher revenues due to the expiration of the effectiveness of the credit on social security contributions. Therefore, Chapter 5 presents an increase in insurance revenues as compared to the no-policy-change scenario in the amount of additional revenues due to the higher ceiling for health insurance.

Table 3.8: Impact of the approved measures on deficits

Main structural reform measures	Categories affected	ESA code		Year 2010	Year 2011	Year 2012
Property taxes		D.29/D.59	CZK bn	2,8	0,1	0,1
			% of GDP	0,1	*0,0*	0,0
Income taxes	Tax on incomes	D.51	CZK bn	1,5	0,1	0,1
			% of GDP	*0,0*	*0,0*	0,0
Excise taxes	Tax on products	D.21	CZK bn	11,1	0,3	0,2
			% of GDP	0,3	*0,0*	*0,0*
VAT	Tax on products	D.21	CZK bn	17,8	0,3	0,4
			% of GDP	*0,5*	0,0	0,0
Income from insurance	Social contributions	D.61	CZK bn	32,6	-31,0	0,0
			% of GDP	0,9	*-0,8*	0,0
Maintaining the 50% refunding of wage compensation to employers		D.1, D.61, D.62	CZK bn	-2,2	2,2	0,0
			% of GDP	*-0,1*	*0,1*	0,0
Payment of sickness benefits	Social benefits other than natural	D.62	CZK bn	4,4	-4,4	0,0
			% of GDP	0,1	*-0,1*	*0,0*
Cancelled valorisation of pensions	Social benefits other than natural	D.62	CZK bn	6,9	-2,4	0,6
			% of GDP	*0,2*	-0,1	0,0
Volume reduction of public sector wages	Employee compensations	D.1	CZK bn	2,0	0,0	0,0
			% of GDP	0,1	*0,0*	0,0
Total impact on the government sector's balance		EDP B.9	CZK bn	76,9	-34,8	1,4
			% of GDP	*2,1*	*-1,0*	0,0

Source: Ministry of Finance.

Table 3.9: Impact of government measures proposed for 2011 – 2012

Main structural reform measures	Categories affected	ESA code		Year 2011	Year 2012
Ceilings on SSC – 6 times of AW	Social contributions	D.61	CZK bn	3,0	0,1
			% of GDP	0,1	*0,0*
Sickness insurance - maintaining of the current state, net impact		D.1, D.61, D.62	CZK bn	6,8	0,2
			% of GDP	*0,2*	*0,0*
PIT, rate of 31 per cent above the ceilings for the SSC	Tax on incomes	D.51	CZK bn	2,0	0,1
			% of GDP	0,1	*0,0*
Decrease in current expenditures			CZK bn	13,3	8,7
			% of GDP	*0,3*	0,2
Decrease in mandatory expenditures	Social benefits other than natural	D.62	CZK bn	5,1	14,5
			% of GDP	0,1	*0,4*
Total impact on the government sector's balance		EDP B.9	CZK bn	30,2	23,6
			% of GDP	*0,8*	*0,6*

Source: Ministry of Finance.