

# 5 Quality of Public Finances – Revenues and Expenditures

## 5.1 General Government Revenues

Due to the unfavourable economic situation, a year-on-year decrease in total general government revenues by almost 6% to about CZK 1,422 billion, or 39.0% of GDP, is expected in 2009. The drop in revenues is primarily the result of tax and social insurance revenues that will decrease by more than 8% compared to 2008 and in relative terms will thus reach approximately 33.2% of GDP.

The revenue side in 2009 also reflects both the impact of the economic crisis on general government tax revenues as well as measures adopted by the government to mitigate the consequences of the crisis. With the exception of excise taxes, the revenues from all important taxes and social contributions are likely to decrease in 2009 (see Table 5.1).

This decrease will be most noticeable in corporate income tax revenues, which will be 21% lower in 2009 compared to the previous year. This fact is based mainly on the highly cyclical nature of the tax base, which, depending on the phase of the economic cycle, fluctuates to a much greater extent than, for example, employees' wages or consumption. Another revenue item for which we expect a significant decline is personal income tax, which should decrease by almost 18% compared to 2008.

Excise taxes increased by 3.6%. This rate of increase, however, also includes the effect of a legislative amendment adopted in 2007 as a result of which the excise tax on tobacco products has been raised since 2008. The lower comparison basis in 2008, from which the 2009 growth is calculated, is based on the effect of stockpiling. Abstracting away from this effect, an observable decline in excise taxes would probably occur as well.

A more substantial increase can be expected on the revenue side in non-tax revenues, mainly due to an increase in the general government investment grants received from other sectors or from abroad. In this case, they are primarily payments from the European Union for projects that it supports.

As a result of measures to strengthen the revenue side (see Box 5.1), the revenue situation of the general government will improve significantly in 2010 and tax revenues will increase by about 1.0 percentage points of GDP to 19.1% of GDP year-on-year (i.e. once again approach the relative level from 2008). In 2010, the improvement will affect all revenue items, most notably the item "taxes on production and imports" (year-on-year increase in revenues by 0.8 percentage points of GDP). In the following years of the outlook, the proportion of tax revenues to GDP will gradually decrease in connection with a decline in the total tax burden, though it will not reach the bottom of 2009 even in the last year of the outlook.

The total tax burden continues to show a decline over time. The year 2010 is an exception that will fully reflect measures on the revenues side adopted to stabilise public finances. Following the expected record drop in the tax burden in 2009 to the level of 33.2% of GDP, caused primarily by decrease in the amount of income tax revenues, it will increase by 1.3 percentage points to 34.5% of GDP in 2010. The trend of gradual reduction in the value of the burden

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established in the past will then continue down to the threshold of about 34.6% of GDP in 2012 (see Table 5.1).

**Table 5.1: General government revenues**

| % of GDP                             | ESA code    | Year<br>2008 | Year<br>2009<br>(1) | Year<br>2010<br>(2) | Year<br>2011<br>(2) | Year<br>2012<br>(2) |
|--------------------------------------|-------------|--------------|---------------------|---------------------|---------------------|---------------------|
| <b>Components of revenues</b>        |             |              |                     |                     |                     |                     |
| <b>Total taxes</b>                   |             | <b>19,6</b>  | <b>18,1</b>         | <b>19,1</b>         | <b>19,1</b>         | <b>19,0</b>         |
| Taxes on production and imports      | D.2         | 11,0         | 11,1                | 11,9                | 11,6                | 11,3                |
| Current taxes on income, wealth etc. | D.5         | 8,6          | 7,0                 | 7,2                 | 7,5                 | 7,6                 |
| Capital taxes                        | D.91        | 0,0          | 0,0                 | 0,0                 | 0,0                 | 0,0                 |
| <b>Social contributions</b>          | <b>D.61</b> | <b>16,2</b>  | <b>15,1</b>         | <b>15,4</b>         | <b>15,6</b>         | <b>15,6</b>         |
| <b>Property income</b>               | <b>D.4</b>  | <b>0,9</b>   | <b>0,9</b>          | <b>1,0</b>          | <b>0,9</b>          | <b>0,9</b>          |
| <b>Other</b>                         |             | <b>4,2</b>   | <b>4,9</b>          | <b>5,1</b>          | <b>5,1</b>          | <b>5,1</b>          |
| <b>Total revenue</b>                 | <b>TR</b>   | <b>40,9</b>  | <b>39,0</b>         | <b>40,5</b>         | <b>40,8</b>         | <b>40,5</b>         |
| <b>p.m.: Tax burden</b>              |             | <b>35,8</b>  | <b>33,2</b>         | <b>34,5</b>         | <b>34,7</b>         | <b>34,6</b>         |

(1) Prediction.

(2) Outlook.

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

### Box 5.1: Measures to strengthen the revenue side approved by Parliament in 2009

#### Personal income tax

In the area of income tax, the tax exemption on compensation (with the exception of that listed by law) to institutional officials was cancelled with a positive annual impact of CZK 0.1 billion and also lump-sum deductible expenses for independent professions and author's royalties were reduced. Here, the revenue increase is projected at CZK 1.5 billion in 2010, then at CZK 1.6 billion in 2011 and CZK 1.7 billion in 2012.

#### Property taxes

From 1 January 2010, the real property tax rate will double for most buildings and plots of land. The revenue from this change, all of which goes into the municipal budgets, is expected to be CZK 2.8 billion for 2010, approximately CZK 2.9 billion for 2011 and about CZK 3 billion in 2012.

#### VAT

From 1 January 2010, both VAT rates will increase by 1 percentage point, i.e. the basic rate will increase from 19% to 20% and the reduced rate will increase from 9% to 10%. The expected revenue from this measure is estimated on an accrual basis to be CZK 17.8 billion in 2010, CZK 18.1 billion in 2011 and CZK 18.5 billion in 2012.

#### Excise taxes

From 1 January 2010, the rates of the following taxes will be adjusted:

- The excise tax on fuels is increased by CZK 1 per litre, with an expected increase in collections of CZK 7.6 billion in 2010, CZK 7.7 billion in 2011 and CZK 7.9 billion in 2012.
- The excise tax on alcohol is increased from CZK 26,500 to CZK 28,500 per hectolitre of ethanol, except for the alcohol in fruit spirits from producer distillation for which the tax rate is increased from CZK 13,300 to CZK 14,300 per hectolitre of ethanol. This measure is expected to increase collection by CZK 0.5 billion in each year of the medium-term outlook of 2010–2012.
- The excise tax on beer is increased in the basic rate by CZK 8 from the current level of CZK 24 for each degree Plato per hectolitre to CZK 32. Reduced rates for small independent breweries are also increased by between CZK 4 (for breweries with production of up to 10,000

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hectolitres per year) and CZK 7.20 (for breweries with production ranging from 150,000 to 200,000 hectolitres). The revenue from this measure is estimated at CZK 1.2 billion in each year of the medium-term outlook of 2010–2012.

- The excise tax on tobacco products will also be increased. In the case of cigarettes, the fixed tax rate will be increased from CZK 1.03 per cigarette to CZK 1.07 per cigarette and the minimum amount of tax will be increased from CZK 1.92 per cigarette to CZK 2.01 per cigarette. The excise tax on tobacco will be increased from CZK 1,280/kg to CZK 1,340/kg. The revenue from this measure is estimated at CZK 1.8 billion in 2010 and CZK 2 billion in each of the subsequent two years.

### Social and health insurance

The reduction in the sickness insurance rate by 0.9 percentage points, initially planned to start from 2010, has been postponed by a year and will apply as from 1 January 2011. At the same time, the ceiling for the premium assessment base increases from 48 times the average monthly wage to 72 times the average monthly wage. In the case of social insurance, this measure is valid only for 2010, while in the case of health insurance the law does not set any time limitation. Furthermore, insurance credits have been cancelled. The impacts of such measures are anticipated based upon the accrual methodology as an increase in revenues by CZK 32.6 billion in 2010 and CZK 1.6 billion in 2011 and 2012 against the no-policy-change scenario.

The impacts of active tax policy measures are summarised in Table 5.2.

**Table 5.2: Impact of revenue measures approved in 2009**

| CZK bn                                     | Year        |             |             |
|--|-------------|-------------|-------------|
|  | 2010        | 2011        | 2012        |
| Property taxes                             | 2,8         | 2,9         | 3,0         |
| Income taxes                               | 1,5         | 1,6         | 1,7         |
| Excise taxes                               | 11,1        | 11,4        | 11,6        |
| VAT  | 17,8        | 18,1        | 18,5        |
| Social and health insurance                | 32,6        | 1,6         | 1,6         |
| <b>Total impact on revenues</b>            | <b>65,8</b> | <b>35,6</b> | <b>36,4</b> |
| <b>Total impact on revenues (% of GDP)</b> | <b>1,8</b>  | <b>0,9</b>  | <b>0,9</b>  |

Source: Ministry of Finance.

Beyond the framework of revenue measures approved for 2010, the government proposed additional measures improving the revenues side of public finances for 2011 and beyond. Specifically, these included a proposed increase in the ceiling for social security payments to six times the average monthly wage, maintaining the current form of sickness insurance and introduction of a second, personal income tax bracket with rate of 31% to be imposed on income exceeding the social security ceiling. A summary of the impacts of the proposed revenue measures in 2011 and 2012 is contained in Table 5.3 below.

**Table 5.3: Impact of revenue measures proposed for 2011 – 2012**

| CZK bn  | Year        |             |
|---|-------------|-------------|
|   | 2010        | 2011        |
| Ceilings on SSC – 6 times of AW                                   | 3,0         | 3,1         |
| Sickness insurance - maintaining of the current state, net impact | 6,8         | 7,0         |
| PIT, rate of 31 per cent above the ceilings for the SSC           | 2,0         | 2,1         |
| <b>Total impact on revenues</b>                                   | <b>11,8</b> | <b>12,2</b> |
| <b>Total impact on revenues (% of GDP)</b>                        | <b>0,3</b>  | <b>0,3</b>  |

Source: Ministry of Finance.

### 5.2 General Government Expenditures

In contrast to the revenue side, general government expenditures will maintain certain growth dynamics and, according to estimates, will increase by 4.8% in 2009. Mainly due to a decline in nominal GDP, general government expenditures will significantly increase as a percent of GDP to 45.5%, which represents a year-on-year jump of 2.5 percentage points.

Compared to 2008, the general government final consumption will increase as a proportion of GDP by 1.5 percentage points. Expenditures on individual consumption and particularly the relatively significant growth of social benefits in kind, especially on health care, are the main reason for its growth.

Given the greater increase in unemployment due to reduction in the number of jobs during the economic downturn, social transfers (mainly to the population) accelerate as well. They will rise by 6.8% compared to 2008. Nevertheless, in comparison with previous years, the increase is relatively modest even in this time of crisis. Another significant factor of the expenditure growth is the interest paid by the general government from its position as a debtor, estimated to increase by ca. 13% in 2009.

Relatively modest growth is expected for 2009 in government investments, which should increase by 1.6% compared to 2008. It is necessary to mention here the vital influence of European funds, without which government investments in 2009 would likely considerably decline. The significant increase in investment grants received (mainly from the EU) corresponds to this development.

The overall dynamics of the expenditures side in 2009 are slowed by sales of Assigned Amount Units of CO<sub>2</sub>, so far considered in a relatively conservative amount of approximately CZK 11 billion as a revenue of the State Environmental Fund. In 2009, only a small portion of these funds (approximately CZK 0.5 billion) is expected to be used, and thus the item significantly improves this year's general government balance.

Other expenditures developed essentially in line with trends stemming from past years.

In addition to the government austerity measures, a number of reductions in social expenditures (see Box 5.2) which will mitigate the growth dynamics of general government expenditures also will come into force in 2010. These include in particular a reduction in the volume of civil servants' wages and salaries (cancellation of administrative positions), freezing of pensions and the planned fixing of expenditures under individual budget chapters. The government is committed to regulate its current expenditures in 2010 so that the general government deficit does not exceed 5.3% of GDP.

Table 5.4: General government expenditures

| % of GDP   | ESA code                       | Year<br>2008 | Year<br>2009<br>(1) | Year<br>2010<br>(2) | Year<br>2011<br>(2) | Year<br>2012<br>(2) |
|--|--------------------------------|--------------|---------------------|---------------------|---------------------|---------------------|
| <b>Components of expenditures</b>                      |                                |              |                     |                     |                     |                     |
| <b>Compensation of employees</b>                       | <b>D.1</b>                     | <b>7,6</b>   | <b>7,9</b>          | <b>7,7</b>          | <b>7,4</b>          | <b>7,0</b>          |
| <b>Intermediate consumption</b>                        | <b>P.2</b>                     | <b>6,2</b>   | <b>6,8</b>          | <b>6,3</b>          | <b>6,0</b>          | <b>5,6</b>          |
| <b>Social transfers</b>                                |                                | <b>18,2</b>  | <b>19,6</b>         | <b>19,8</b>         | <b>19,5</b>         | <b>19,1</b>         |
| Social transfers in kind supplied via market producers | D.6311,<br>D.63121,<br>D.63131 | 5,4          | 5,8                 | 5,8                 | 5,8                 | 5,7                 |
| Social transfers other than in kind                    | D.62                           | 12,8         | 13,8                | 14,0                | 13,7                | 13,4                |
| <b>Interest expenditure</b>                            | <b>EDP D.41</b>                | <b>1,1</b>   | <b>1,3</b>          | <b>1,7</b>          | <b>2,0</b>          | <b>2,1</b>          |
| <b>Subsidies</b>                                       | <b>D.3</b>                     | <b>1,7</b>   | <b>1,8</b>          | <b>1,7</b>          | <b>1,7</b>          | <b>1,7</b>          |
| <b>Gross fixed capital formation</b>                   | <b>P.51</b>                    | <b>5,0</b>   | <b>5,1</b>          | <b>5,4</b>          | <b>5,6</b>          | <b>5,7</b>          |
| <b>Other</b>   |                                | <b>3,2</b>   | <b>3,1</b>          | <b>3,1</b>          | <b>3,3</b>          | <b>3,5</b>          |
| <b>Total expenditures</b>                              | <b>TE</b>                      | <b>43,0</b>  | <b>45,5</b>         | <b>45,8</b>         | <b>45,6</b>         | <b>44,7</b>         |
| <b>p.m.: Government consumption (nominal)</b>          | <b>P.3</b>                     | <b>20,4</b>  | <b>21,9</b>         | <b>21,3</b>         | <b>20,6</b>         | <b>19,6</b>         |

(1) Prediction.

(2) Outlook.

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

## Box 5.2: Changes in social expenditures approved by Parliament in 2009

### Expenditures associated with social and health insurance

The assessment basis for the state payment to the public health insurance system has been newly revised with a fixed amount stipulated by law (from 1 January 2010 in the amount of CZK 5,355) with the possibility to adjust its amount by a government decree. Total savings are expected to reach CZK 4.5 billion in 2010 and CZK 7 billion in 2011. Although in this case the impact on the state budget is positive, the public health insurance balance will worsen by the same amount. The overall impact on public budgets, therefore, is zero.

Within the payment of wage compensation for sick leave, which in 2010 remains in its former arrangement, the 50% refund for employers is maintained. This will increase expenditures by CZK 2.2 billion in that year.

### Payments of social benefits

In the area of social benefits, in particular an increase in benefits proposed in the Act on Promotion of Economic Growth and Social Stability was cancelled. These include unemployment benefits as well as the child benefit, which was to increase by CZK 50 according to the original proposal. We have not quantified the impacts of these changes as the given measures were cancelled practically before their implementation.

The benefit parameters for calculating payments from sickness insurance have changed. In the period from 1 January 2010 to 31 December 2010, in adjusting the daily assessment base for calculating the maternity benefit and compensatory contribution for pregnancy and maternity leave the first reduction threshold of 90% is calculated into the amount. The amount of the sickness and maternity benefits per calendar day in the period from 1 January 2010 to 31 December 2010 is 60% of the daily assessment base. During the period from 1 January 2010 to 31 December 2010, the support period for giving care is a maximum 6 calendar days, and no more than 13 calendar days if the person is a sole employee taking permanent care of at least one child under 16 years of age without having completed the compulsory education. The support period starts from the fourth day of the need for treatment or care. Moreover, the percentage rate for the daily sickness contribution during long-term inability to work was reduced (from the 31st to the 60th day of inability to work from 66% to 60% and from the 61st day of inability to work onward from 72% to 60%). The savings impact of these measures is approximately CZK 4.4 billion under the accrual methodology.

### Wage policy

In the area of wages and salaries of state employees, administrative positions have been cancelled with a savings impact on expenditures in 2010 of CZK 3.8 billion. However, the reduction in premium and tax payments in the

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amount of about 1.8 billion must be deducted from this impact. This cancellation of administrative positions is of a permanent character.

### Freezing of pensions

In the Czech Republic, the increase in pensions is set so that the amount of the average retirement pension increase corresponds to at least 100% of the growth in prices as well as to at least one third of the rise in real wages, if the increase thus calculated is at least 2%. Since the latter condition was not met, however, the government decided not to carry out valorisation as at 1 January 2010. This regulation is to have a savings effect of about CZK 6.9 billion in 2010, approximately CZK 4.5 billion in 2011 and approximately CZK 5.1 billion in 2012.

**Table 5.5: Impact of changes in social acts**

| CZK bn  | Year        |            |            |
|---|-------------|------------|------------|
|   | 2010        | 2011       | 2012       |
| Change in assessment base for public health insurance           | 0,0         | 0,0        | 0,0        |
| Retaining reimbursement of 50 % wage compensations to employers | -2,2        | 0,0        | 0,0        |
| Payment of health insurance                                     | 4,4         | 0,0        | 0,0        |
| Cancelled valorization of pensions                              | 6,9         | 4,5        | 5,1        |
| Cancellation of function posts in public sector                 | 2,0         | 2,0        | 2,0        |
| <b>Total impact on balance</b>                                  | <b>11,1</b> | <b>6,5</b> | <b>7,1</b> |
| <b>Total impact on balance (% GDP)</b>                          | <b>0,3</b>  | <b>0,2</b> | <b>0,2</b> |

Source: Ministry of Finance.

Similarly as in the case of the revenues side, the government proposed additional measures for 2011 and 2012 beyond the framework of expenditure savings measures approved for 2010. These include in particular reduction of current expenditures of the budget chapters and overall reduction of mandatory expenditures. In their overall impact, these measures represent an improvement in public revenues in 2011 and 2012 by 0.5 and 1.0 percentage point of GDP, respectively. Table 5.6 below provides a quantification of these impacts.

**Table 5.6: Impact of expenditure measures proposed for 2011 – 2012**

| CZK bn   | Year        |             |
|--|-------------|-------------|
|  | 2011        | 2012        |
| Decrease in current expenditures               | 13,3        | 22,0        |
| Decrease in mandatory expenditures             | 5,1         | 19,6        |
| <b>Total impact on expenditures</b>            | <b>18,4</b> | <b>41,6</b> |
| <b>Total impact on expenditures (% of GDP)</b> | <b>0,7</b>  | <b>1,5</b>  |

Source: Ministry of Finance.

Table 5.7 and Chart 5.1 show a continuing year-on-year decrease in the proportion of total expenditure to GDP in the structure of general government expenditures by function (COFOG). The decline was reflected in all items of the COFOG classification with the exception of social protection, which recorded a slight year-on-year increase from 12.7% of GDP to 12.9% of GDP. In contrast, the greatest relative decline occurred in housing and community infrastructure during the period 2006–2007 (from 1.6% of GDP in 2006 to 1.1% of GDP in 2007).

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**Table 5.7: General government expenditures by function**

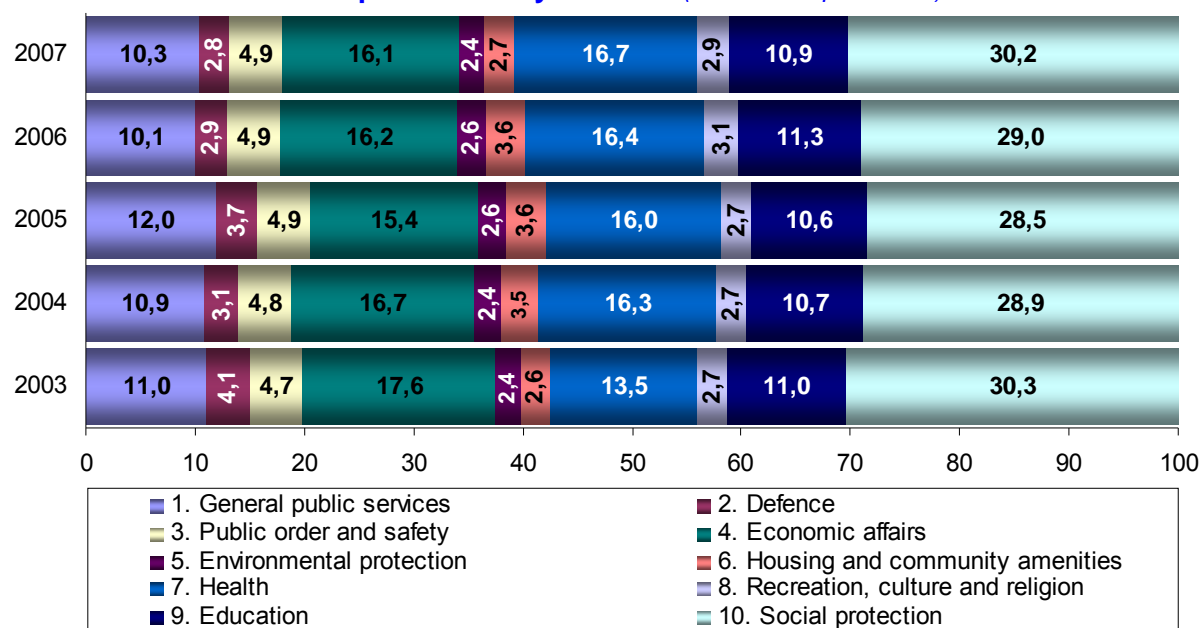
| % of GDP                            | ESA code | Year 2003 | Year 2004 | Year 2005 | Year 2006 | Year 2007 |
|-------------------------------------|----------|-----------|-----------|-----------|-----------|-----------|
| 1. General public services          | 1        | 5,2       | 4,9       | 5,4       | 4,4       | 4,4       |
| 2. Defence                          | 2        | 1,9       | 1,4       | 1,6       | 1,3       | 1,2       |
| 3. Public order and safety          | 3        | 2,2       | 2,2       | 2,2       | 2,2       | 2,1       |
| 4. Economic affairs                 | 4        | 8,3       | 7,5       | 6,9       | 7,1       | 6,9       |
| 5. Environmental protection         | 5        | 1,2       | 1,1       | 1,2       | 1,2       | 1,0       |
| 6. Housing and community amenities  | 6        | 1,2       | 1,6       | 1,6       | 1,6       | 1,1       |
| 7. Health                           | 7        | 6,4       | 7,3       | 7,2       | 7,2       | 7,1       |
| 8. Recreation, culture and religion | 8        | 1,3       | 1,2       | 1,2       | 1,3       | 1,3       |
| 9. Education                        | 9        | 5,2       | 4,8       | 4,8       | 4,9       | 4,7       |
| 10. Social protection               | 10       | 14,4      | 13,0      | 12,8      | 12,7      | 12,9      |
| <b>Total expenditure</b>            | TE       | 47,3      | 45,1      | 45,0      | 43,8      | 42,6      |

Note: Total expenditures do not correspond precisely to the current version of the yearly national accounts. This is due to the different periodicity for publishing the main aggregates of the annual national accounts (every half year in April and October) and the expenditures of general government institutions by function (once a year in December).

Source: Czech Statistical Office.

In the following chart, expenditures for individual purposes are shown as their share of total general government expenditures.

**Chart 5.1: Government expenditures by function (% of total expenditures)**



Source: Czech Statistical Office.