

## 3 General Government Deficit and Debt

### 3.1 Current Development of Public Finances

General government finances ended 2007 with an unexpectedly good result. The general government balance reached -1.0% of GDP, which represents a year-on-year improvement of 1.7 percentage points. This figure is a full 2.4 percentage points better than the assumptions from last year's CP update.

The significant decline in the general government deficit is due to a combination of several positive factors.

- The Czech economy was at the peak of the economic cycle, and additional revenues were used wholly to reduce the deficit.
- The economic results of recent years are influenced by the extensive transfers of unspent budgetary allocations to reserve funds (RF). Contrary to the originally anticipated integration of part of the reserves into expenditures, transfers to RF reached a record level. The volume of funds accumulated in the reserves of state organisational units as of the end of 2007 amounted to 2.7% of GDP and represents resources for additional expenditures in the upcoming years.<sup>5</sup>
- The apparent improvement in the local government balance by 0.9 percentage points of GDP was primarily due to a drop in expenditures for gross fixed capital formation.

The expected increase in social expenditures due to measures accepted in the first half of 2006 was confirmed. The acceleration of social spending, however, was more than offset by not carrying out in particular a large volume of investment expenditures. Thus, the structure of government expenditures recorded an adverse shift.

The economic performance in 2008 is positively affected by the impacts of a set of measures approved in 2007 and aimed at stabilising public finances. These measures are more or less neutral on the side of tax revenues and yield significant savings in social expenditures. The main goal of these measures is to provide for reducing the structural deficit towards the medium-term budgetary objective. Space is created for financing expenditure priorities having positive affects on economic growth and for increasing motivation with respect to economic activity by limiting mandatory (especially social) expenditures.

By contrast, the slowing of economic growth, which is reflected in the smaller increase in revenues particularly from indirect taxes, has a negative effect on government revenues. On the expenditures side, the extraordinary indexation of pensions due to the rise in inflation and the increased drawing of funds accumulated in RF are worsening the economic performance. Transacting with reserve funds remains the greatest uncertainty of the fiscal outlook in both directions. The forecasted outcomes for general government are based on the assumption that similar savings will be achieved as in 2007.

---

<sup>5</sup> The state of RF, however, does not necessarily in a full amount indicate a potential negative impact on the general government balance in the case of incorporating reserves into expenditures. More than half of the transferred funds represent pre-financing for projects co-financed from EU funds, which will be covered at the time of their implementation by revenues coming from the EU budget.

The general government balance should be around -1.2% of GDP in 2008, which some 1.7 percentage points better than figured in the original fiscal target and the assumption in last year's CP update. The deficit, however, will probably deepen slightly compared to 2007, as the effect of the less favourable economic environment and the impact of integrating part of reserves into expenditures will outweigh savings resulting from stabilisation measures.

## 3.2 The Medium-Term Fiscal Outlook

### The budget for 2009

The state budget for 2009 emerges from the approved expenditure limit, which should ensure achieving a general government budget balance of around -1.6% of GDP.<sup>6</sup> Considering the better-than-expected development of public finances in 2007 and 2008, it can be expected to achieve a deficit that is considerably lower than was planned in last year's CP.

In comparison with the previous year, however, the general government deficit will still deepen. The main causes are the further slowing in economic growth and the expected drawing of reserve funds, which may increase general government expenditures above the budgeted allocation. The higher indexation of certain social benefits (especially pensions) due to high inflation in 2008 was compensated with savings in other areas, given the obligation of adherence of the spending limits.

Risks to the estimate of the general government balance point to a higher deficit, especially in connection with the uncertain development of the external environment. In the event of faster cooling of the economy, which would be reflected in lower budgetary revenues, the government nevertheless expressed its intention to implement additional spending cuts that will ensure achieving the approved state budget deficit. This decision reflects the priority to reduce the general government deficit towards the medium-term budgetary objective and to subsequently enable the full operation of automatic fiscal stabilisers.

**Table 3.1: General government balance by sub-sector**

% of GDP	ESA code	Year 2007	Year 2008 (1)	Year 2009 (2)	Year 2010 (2)	Year 2011 (2)
<b>Net lending (+)/borrowing (-) (EDP B.9) by sub-sectors</b>						
<b>General government</b>	<b>S.13</b>	<b>-1,0</b>	<b>-1,2</b>	<b>-1,6</b>	<b>-1,5</b>	<b>-1,2</b>
<b>Central government</b>	<b>S.1311</b>	<b>-2,0</b>	<b>-1,6</b>	<b>-1,7</b>	<b>-1,5</b>	<b>-1,2</b>
<b>Local government</b>	<b>S.1313</b>	<b>0,5</b>	<b>0,0</b>	<b>0,0</b>	<b>0,0</b>	<b>0,0</b>
<b>Social security funds</b>	<b>S.1314</b>	<b>0,5</b>	<b>0,3</b>	<b>0,1</b>	<b>0,0</b>	<b>0,0</b>

(1) Notifications (October 2008).

(2) Outlook.

Source: Czech Statistical Office (2007), Ministry of Finance.

<sup>6</sup> The planned balance in 2009 is identical with the draft state budget. The negative impact of the poorer macroeconomic scenario as compared to the draft state budget is more or less offset by revisions to the balance estimate in 2007 from the April estimate of -1.6% to -1.0% of HDP in the October notifications.

## Outlook for 2010 and 2011

According to current estimates, the approved expenditure limit for 2010 should lead to achieving a general government balance of around -1.5% of GDP. In 2011, an improvement in the balance to -1.2% of GDP can be expected. While the dynamics of government expenditures will be roughly stable, tax revenues growth will accelerate due to the ending of the process of reducing tax rates.

The drop in the general government budget balance in 2010 and 2011 should make it possible to achieve the medium-term budgetary objective for the structural balance of -1.0% of GDP by 2012 at latest.

### 3.3 The Structural Balance and the Fiscal Stance

The Czech economy most likely reached the peak of its economic cycle in 2007. The fiscal scenario until 2011 is based on an assumption of gradually closing the positive output gap and returning the nominal general government balance to its structural level.

The structural balance in 2008 and 2009 should reach an approximately stable level of around -1.5% of GDP. The increase in the nominal deficit in 2009, therefore, should be primarily of a cyclical nature and due to the relatively sharp expected slowing in economic growth.

According to current estimates of tax revenues, compliance with the expenditure frameworks in 2010 and 2011 should imply a slow improvement of the structural balance towards the medium-term budgetary objective.

**Table 3.2: Structural balance<sup>(a)</sup>**

% of GDP	ESA code	Year 2007	Year 2008 (1)	Year 2009 (2)	Year 2010 (2)	Year 2011 (2)
<b>1. Real GDP growth (%)</b>		6,6	4,4	3,7	4,4	5,2
<b>2. Net lending of general government</b>	<b>EDP B.9</b>	-1,0	-1,2	-1,6	-1,5	-1,2
<b>3. Interest expenditure</b>	<b>EDP D.41</b>	1,1	1,2	1,2	1,1	1,0
<b>4. One-off and other temporary measures</b>		-0,3	-0,1	0,0	0,0	0,0
<b>5. Potential GDP growth (%)</b>		5,1	5,2	5,0	4,8	4,8
<i>Contributions:</i>						
- total factor productivity		4,0	3,8	3,5	3,4	3,5
- labour		0,1	0,4	0,4	0,3	0,1
- capital		1,0	1,1	1,1	1,1	1,2
<b>6. Output gap</b>		2,0	1,2	-0,1	-0,5	-0,1
<b>7. Cyclical budgetary component</b>		0,6	0,3	0,0	-0,1	0,0
<b>8. Cyclically-adjusted balance (2 – 7)</b>		-1,6	-1,6	-1,6	-1,4	-1,2
<b>9. Cyclically-adjusted primary balance (8 + 3)</b>		-0,4	-0,4	-0,4	-0,3	-0,1
<b>10. Structural balance (8 – 4)</b>		-1,3	-1,5	-1,5	-1,4	-1,1

(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.

The fiscal policy setting will be practically neutral. Only very limited discretionary effects can be expected on aggregate demand. The inflow of resources from EU funds remains a significant expansive factor. These resources do not in principle have a direct effect on the general government balance, because they represent at one and the same time both

government revenue and expense. They do, however, represent extensive additional demand-creating resources.

#### 3.4 Government Debt

In the overall outlook horizon, the general government debt should be lower than that given by the assumptions in last year's CP update. The main factor is the lower need for financing the deficit, which, despite the expected slowing of economic growth, has fallen below the level stabilising the debt-to-GDP ratio. This will result in a drop in the proportion of debt to GDP for the entire period through 2011.

**Table 3.3: Government debt by sub-sector**

% of GDP	ESA code	Year 2007	Year 2008 (1)	Year 2009 (2)	Year 2010 (2)	Year 2011 (2)
<b>Gross debt by sub-sectors</b>						
<b>General government</b>	<b>S.13</b>	<b>28,9</b>	<b>28,8</b>	<b>27,9</b>	<b>26,8</b>	<b>25,5</b>
Central government	S.1311	26,5	26,5	25,7	24,8	23,7
Local government	S.1313	2,5	2,3	2,2	2,0	1,9
Social security funds	S.1314	0,0	0,0	0,0	0,0	0,0

(1) Notifications (October 2008).

(2) Outlook.

Sources: Czech Statistical Office (2007), Ministry of Finance.

At the same time, privatisation of the company Správa Letiště Praha, s.p. (Prague Airport) is expected in 2009. Cash revenues from this privatisation will further reduce the need for debt financing of the deficit.

The accumulation of currency and deposits made in 2007 positive contribution to the change in debt. A similar development is expected also in 2008. In the upcoming years, however, the use of these funds to finance government expenditures can be expected. This will be reflected in a negative contribution to the change in debt.

Table 3.4: Government debt and related indicators

% of GDP	Year 2007	Year 2008 (1)	Year 2009 (2)	Year 2010 (2)	Year 2011 (2)
<b>Gross debt</b>	28,9	28,8	27,9	26,8	25,5
<b>Change in gross debt ratio</b>	-0,7	-0,1	-0,9	-1,0	-1,3
<b>Contributions to change in gross debt</b>					
<b>Primary balance</b>	-0,2	0,0	0,4	0,4	0,1
<b>Interest expenditure</b>	1,1	1,2	1,2	1,1	1,0
<b>Nominal GDP growth</b>	-2,6	-2,0	-1,6	-1,9	-1,9
<b>Stock-flow adjustment</b>	1,0	0,7	-1,0	-0,6	-0,6
- Difference between cash and accruals	-0,4	-0,2	-0,1	-0,1	0,0
- Net accumulation of financial assets	1,5	1,0	-0,9	-0,6	-0,6
of which: Privatisation proceeds <sup>(3)</sup>	0,4	0,7	1,9	0,0	0,0
- Valuation effects and other	-0,1	-0,2	0,0	0,0	0,0
<b>p.m. implicit interest rate on debt</b>	3,9	4,2	4,3	4,2	4,1

(1) Notifications (October 2008).

(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 outlook does not take into account any heretofore unapproved privatisation transactions. Should some additional privatisation projects take place, and should privatisation revenues be used to finance government expenditures, then the share of government debt in GDP would fall at a faster rate than in the outlook.

### 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. The impacts of these measures were accounted for and enumerated already in last year's CP update. So far, it has not been necessary to revise the impact estimates more significantly. 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 to determine with certainty whether this results from an inaccurate impacts estimate or is a distinctly autonomous development owing to higher-than-expected inflation, lower-than-expected economic growth, and other factors.

On the revenues side, new measures in the area of taxes and social contributions were incorporated into the current CP scenario, while on the expenditures side the effect of the decision to carry out an extraordinary adjustment of retirement pensions especially due to the rise in inflation at the turn of 2007 to 2008 was incorporated. The fiscal scenario also includes the effects of measures presented in the National Reform Programme (NPR). Fiscally significant steps are described and quantified in Section 5. The majority of NPR measures, however, are covered within the expenditure limits of the individual ministries, or state funds, and as such do not affect the fiscal scenario.

### 3 General government deficit and debt

Table 3.5 summarises the incremental effects<sup>7</sup> of the fiscally important economic policy measures that change the fiscal outlook as compared to last year's CP update.

**Table 3.5: Effects of new measures significant for the budget**

Main structural reform measures	Categories affected	ESA code		Year 2008	Year 2009	Year 2010	Year 2011
Maintaining the PIT rate at the level of 15% instead of planned decrease to 12.5% in 2009	Current taxes on income and wealth	D.5	CZK bn	-	10,0	-	-
			% of GDP	-	0,2	-	-
Narrowing the CIT base	Current taxes on income and wealth	D.5	CZK bn	-2,2	-0,2	-	-
			% of GDP	-0,1	0,0	-	-
Decrease in the rate of social contributions paid by employees by 1.5 p.p. in 2009	Social contributions	D.61	CZK bn	-	-18,4	-0,7	-1,3
			% of GDP	-	-0,5	0,0	0,0
One-off indexation of pensions	Social benefits in cash	D.62	CZK bn	-6,7	6,7	-	-
			% of GDP	-0,2	0,2	-	-
Total impact on the budgetary balance		EDP B.9	CZK bn	-8,9	-1,9	-0,7	-1,3
			% of GDP	-0,2	0,0	0,0	0,0

Source: Ministry of Finance.

<sup>7</sup> By contrast, the effects in Section 5 are enumerated in comparison with the no-policy-change scenario and are therefore cumulative.