Fiscal Policy Response to the Deteriorating Economic Outlook - Stimulus Measures

March 17, 2009

This note is aimed to provide an update on the fiscal policy developments in the Czech Republic since the beginning of the year. Due to the unprecedented development of the economic outlook the government has taken a number of steps in the field of fiscal policy. The note presents their current status and expected fiscal impacts.

All measures undertaken by the Government in reaction to the worsening economic outlook over the past couple of months can be divided into three groups:

(i) Measures approved by the end of the last year

These measures are legally binding and are in full included in Ministry of Finance's (MoF) projections of the deficit and debt. They can be divided into two sub-groups.

A) The first subgroup of the measures consists of changes stemming from the public finance reform approved by the Parliament in 2007. The main aim of the reform was to secure the budgetary sustainability. Therefore, tax reductions were compensated by a decrease in mandatory social expenditures. These measures are described in detail in the documents "Convergence Programme" and "Fiscal Outlook of the Czech Republic".

B) The second subgroup consists of measures introduced and approved as a part of the first anti-crisis package and communicated to the European Commission by the end of 2008 in form of Addendum to updated Convergence programme. These measures are listed below:

Table 1: Measures for stimulating the economy approved in 2008 (in bn CZK)

Revenues	ESA 95		
	Revenue	Expenditure	**(R-E)**
Decrease in social security contribution paid by employees by 1.5 p.p.	-18,4		**-18,4**
Subtotal	-18,4		**-18,4**
Expenditures			
Additional increase of public sector wages in comparison with the planned amount	0,4	2,7	**-2,3**
One-off increase in capital of the Czech Export Bank, the Export Guarantee and Insurance Corporation, the Czech-Moravian Guarantee and Development Bank 1)			**0,0**
Increase in capital of the Support and Guarantee Agricultural and Forestry Fund 1)			**0,0**
Allocation for investment incentives for projects of technology centres		0,6	**-0,6**
Support of EU funds co-financing aimed at projects improving environment		0,5	**-0,5**
Allocation for construction and modernization of infrastructure within the State Fund for Transport Infrastructure		14,4	**-14,4**
Subtotal	0,4	18,2	**-17,8**
Overall share on GDP			**-0,9%**

1) Capital injections do not influence the size of the general government deficit, only that of the debt. However, it is a cash expenditure of the state budget. The total injection to the Czech Export Bank reaches CZK 2 bn and CZK 0.3 bn to the Support and Guarantee Agricultural and Forestry Fund.

Gross impact of the increase of public sector wages reached CZK 2.7 bn. However due to additional tax and social security contributions which automatically improve the revenue side of the budget, net impact on the balance is estimated to make CZK 2.3 bn.

The reduction on the side of social security contributions has replaced an approved decrease in personal income tax, i.e. it has been financed by the planned decrease in mandatory social expenditures. As opposed to others, this specific measure is not of a one-off character.

The allocation for the State Fund for Transport Infrastructure (SFTI) was included in the early drafts of the state budget. For that reason MoF took into account this figure in the Convergence Programme. Afterwards, it was decided that this measure would be partially abolished to decrease the planed deficit. Finally, it was restored as a crisis remedy. Therefore, this measure does not constitute additional expenditure for the state budget in comparison with the budget draft from the last year's spring[1].

To conclude, the impact of these measures on deterioration of the structural component of the government balance makes just around 0.1 per cent of GDP, as just the increase of public sector wages was a really new measure.

(ii) One-off measures approved by the government in January 2009

First subgroup of these measures was designed to improve budget balance. The second subgroup slightly strengthens previous expansion measures. All these measures are in force at the moment.

A) Measures aimed at improving budget balance.

Dissolution of reserve funds of around CZK 34 bn. This measure has just cash impact on the state budget. It means that the deficit according to ESA 95 methodology will not be directly influenced. However, it implies that the governmental debt interest payments will not amount to the level they otherwise would. An estimated impact of this saving amounts to CZK 1.5 bn.

The government has decided that the planned ordinary expenditures of the state budget will be cut by CZK 6.5 bn. Such a situation allows for either decrease in the deficit or provides the government an extra space for other expenditures.

B) In case of the Czech-Moravian Guarantee and Development Bank, the total increase in capital equal to CZK 1.1 bn. This transaction is financed by PHARE, free internal resources and preceding profit. The governmental balance will be affected by lower dividend of CZK 0.5 bn.

Table 2: One-off measures approved by the government in January 2009 (in bn CZK)

	ESA 95		
	Revenue	Expenditure	**(R-E)**
Integration of the Resources from Reserve Funds		-1,5	**1,5**
Decrease of ordinary expanditures		-6,5	**6,5**
One-off increase in capital of the Czech-Moravian Guarantee and Development Bank	-0,5		**-0,5**
A subsidy to the Support and Guarantee Agricultural and Forestry Fund		2,0	**-2,0**
A subsidy for the Masaryk University		0,3	**-0,3**
Additional support of EU funds co-financing aimed at projects improving environment		0,5	**-0,5**
Total			**4,7**
Share on GDP			**0,1%**

(iii) Measures of so-called second anti-crisis package

[1] The amount of CZK 14.4 bn. corresponds to the methodology of the Addendum to the 2008 Updates of the Stability and Convergence Programmes as set by EC. In the National Anti-Crisis Plan of the Czech Republic, the figure of CZK 7.2 bn. is presented. The difference can be explained by the fact that for national purposes a different initial base for comparison was used.

The government has approved a second package of stimulus measures. Majority of these measures can be executed by the government directly. However, the reduction of social security contributions, faster depreciation and VAT deduction must be approved by the Parliament. The VAT deduction has been already approved by the Chamber of Deputies.

In this package, several areas have been identified that should receive a priority state support within the ongoing economic and financial crisis: employment, easier financing of SMEs, environmental investments and regional transport accessibility.

Table 3: Measures for stimulating the economy proposed in February 2009 (in bn CZK)

	ESA 95		
	Revenue	Expenditure	**(R-E)**
Reductions for Employers on SSC and the Contribution for the State Employment Policy (2009-2011)	-18,0		**-18,0**
Faster Depreciation in the 1st and 2nd Depreciation Group (2009 - 6/2010)	-9,4		**-9,4**
Broadening of the VAT Deductions on Personal Vehicles	-2,4		**-2,4**
Guarantee and Support of Small- and Med-Sized Enterprises' Credits		2,1	**-2,1**
Faster VAT refunds			**0,0**
Subsidy Programme of an Energy Buildings' Demandingness Reduction		6,0	**-6,0**
Boost of the Subsidy Programme "PANEL"		0,6	**-0,6**
Expenditure Increase in the Provision of Transport Service		2,0	**-2,0**
Abolition of advances of CIT/PIT for small enterprises (2009)		1,0	**-1,0**
Total			**-41,5**
Share on GDP			**-1,1%**

Note: The presented abolition of advances of income taxes for small enterprises (less than 5 employees) has no direct impact in the ESA methodology. However, it will deteriorate the cash balance. The figure of CZK 1 bn represents an additional increase in interest payments which correspond to higher debt.

Primary support for employment should be provided through deductions of employers’ social security contributions, thus lowering labour costs. This measure will be in force from 2009 to 2011. Additional funding may also be provided for programmes such as “PANEL” – aimed at a renovation of housing estate buildings.

The first two measures in the Table 3 and the abolition of advances of income taxes are designed for limited time period as stated in brackets. Conversely, the VAT deduction and faster VAT refunds should be permanent. The remaining measures are one-offs.

The government has made it clear already a number of times that the debt burden cannot be unreasonably increased and the short-term economic stimulus cannot make the government to resign from long-term responsibilities, such as the healthcare and pension reforms. There is a strong commitment to budgetary discipline and expenditure ceilings.