

4 General Government Finances – Deficit and Debt

4.1 The Medium-Term Budgetary Outlook

The Czech Republic's strategy in the area of budgetary policy is mainly driven by its efforts to eliminate the excessive general government deficit.

The systematic endeavour to reduce the government deficit was commenced by the adoption of the Conception of Public Finance Reform in 2003. A collection of measures on the revenue and expenditure sides of public budgets, along with favourable economic development, helped to successfully meet the reform objectives in 2004 and 2005. It is anticipated that the fiscal target will also be reached in 2006.

Development in the upcoming period is encumbered by the political cycle prior to the parliamentary elections in 2006 and the post-election political stalemate. Owing to these factors, reform efforts before the elections were weakened, and immediately following the parliamentary elections, there was no opportunity to implement substantial measures.

The latest development shows that the Czech Republic will not be capable of reaching the fiscal targets for 2007/2008 defined in last year's CP. The original goal of eliminating the excessive deficit in 2008 in a sustainable manner will apparently be postponed by at least one year. The CP is based fully on the approved act on the state budget for 2007 and its medium-term outlook for 2008/2009, which assumes a temporary increase in the government deficit in 2007 to 4.0% of GDP and then the continued reduction of the deficit to 3.5% in 2008 and to 3.2% in 2009. The planned measures, which should help speed up fiscal consolidation and which are contained in the new government's programme declaration (see Section 9), are not reflected in the submitted quantitative scenario.

The planned reduction in the government deficit will require strengthening of the role of the fiscal targeting regime and renewal of the credibility of the binding expenditure frameworks and of public finances' medium-term focus that the new government has explicitly committed itself to in its declaration.

The expected increase in the government deficit in 2007 means a temporary interruption in the consolidation strategy and will cause a delay in reaching the medium-term budgetary objective established for the Czech Republic as a part of the fiscal rules of the Stability and Growth Pact. The medium-term objective for the general government balance is -1.0% of GDP.

Starting in 2008, the medium-term outlook will be based on the obligation to continue reducing the government deficit and on the approved medium-term expenditure frameworks. The submitted strategy was approved by the government and the Chamber of Deputies of the Czech Parliament during negotiations on the 2007 state budget. Assuming that the same rate of deficit reduction is maintained at least at the level of minimum fiscal effort, the Czech Republic could reach its medium-term budgetary target of -1.0% of GDP in 2013.

Table 4.1: General government medium-term outlook – deficit by sub-sector

% of GDP	ESA code	Year 2005	Year 2006 (1)	Year 2007 (2)	Year 2008 (2)	Year 2009 (2)
Net lending/borrowing (EDP B.9) by sub-sectors						
General government	S.13	-3,6	-3,5	-4,0	-3,5	-3,2
Central government	S.1311	-3,6	-3,7	-3,8	-3,3	-3,0
Local government	S.1313	-0,1	0,0	-0,2	-0,2	-0,2
Social security funds	S.1314	0,1	0,1	0,0	0,0	0,0

(1) Notifications (October 2006)

(2) Outlook

Source: Czech Statistical Office, Ministry of Finance

Budgetary policy settings must increasingly account for the long-term challenges of public finances. The Czech Republic is one of the countries with the least favourable long-term fiscal outlook. The demands for a medium-term public finance position will, therefore, be significantly influenced by the reform structure for the pension and healthcare systems.

4.2 General Government Balance from 2005 to 2007

2005

The previous CP worked with an expected general government deficit in 2005 of 4.8% of GDP. According to preliminary figures, this deficit registered a substantially lower level of 3.6 %.

Higher-than-expected tax collections were reflected on the revenue side. This was the result of substantial changes in the structure of taxes made in 2004, which complicated the estimate of tax revenues. It was also partially the result of slightly faster growth for the nominal tax bases in comparison with the assumptions.

For the second year in a row, the possibility of transferring unused resources to the reserve funds has had a positive impact on the expenditure side of the balance. For the first time in 2004, the budgetary rules allowed an unlimited amount of funds to be carried over into future years. The state organisational units transferred CZK 24.7 billion in 2004. This situation was repeated in 2005, and the transfer of funds improved the balance by CZK 24.9 billion (0.8% of GDP). The resources in the reserve funds could be used in future years to increase expenditures and, therefore, add a considerable amount of uncertainty to the general government's expected performance.

Expenditures in 2005 were influenced by two substantial one-off transactions that have had an adverse effect on the general government deficit. These were the lease of Gripen aircraft for CZK 9.6 billion (0.3% of GDP) and forgiving Syria's unrecoverable debt amounting to CZK 18.7 billion (0.6% of GDP).

2006

The fiscal target for the general government deficit in 2006 was set at 3.8% of GDP in the last CP. Current development indicates that the general government deficit could be slightly lower. In the autumn notifications, the Ministry of Finance estimated a deficit of CZK 110.6 billion (3.5% of GDP).

General government revenues roughly correspond to last year's assumptions. Favourable economic development and the continuing rise in corporate profitability are reflected in an increase of approximately CZK 10 billion in corporate income tax collection (0.3% of GDP). On the other hand, excise taxes have registered lower performance, whose prediction is complicated by producers' overstock due to the current increase in the tax rates for tobacco products. Personal income tax revenues are more adversely affected by the introduction of joint taxation for spouses with children than originally expected.

The increase in social transfers and strengthening of general government investment activities contribute the most to expenditure growth. However, government consumption has risen at a relatively lower pace and is essentially flat in real term. In 2006, it was decided to stabilise the volume of resources in the reserve funds (see Section 8.1). The possibility of carrying over funds to future periods should not, therefore, have any impact on the general government deficit in 2006. The accuracy of the deficit estimate is, nevertheless, highly dependent on meeting this assumption.

2007

In 2007, the Czech Republic will not be capable of fulfilling the general government's deficit target of 3.3% of GDP set in the last CP. Without implementing additional austerity measures, the deficit will be in a range of 4.0% of GDP.

Preparations for the 2007 state budget had begun during the period prior to the parliamentary elections. The reform efforts from 2003 to 2005 were weakened by the effect of the position in the political cycle and a number of acts were passed that increase general government expenditures for upcoming years. The complicated post-election political situation stemming from the equal division of power between the left and right political parties prevented the adoption of appropriate budget cuts along with the already approved measures. This has also caused the set expenditure frameworks to be overshot by CZK 56.6 billion in 2007 (1.6% of GDP) and CZK 56.8 billion in 2008 (1.5% of GDP).

The main cause of the worsening outlook is rooted in the expenditures for the social sphere. The package of legislation approved at the end of 2005 and during 2006 will result in an increase in social transfers in 2007 of around CZK 36.2 billion (1.1% of GDP). This will cause further acceleration of annual social expenditure growth from 7.3% in 2006 to 9.7% in 2007.

The item with the second highest contribution to expenditure dynamics continues to be gross fixed capital formation, in which resources from EU funds have begun to play a larger role. With respect to the anticipated increase in interest rates, a rise of about one third in the costs for debt service can also be expected (from 1.1% to 1.4% of GDP). The expenditures for collective consumption will continue to increase at a slower rate of around 5% in nominal terms.

General government revenues in 2007 will continue to draw on the structural changes implemented since the start of the public budget reform. A change in the tax structure and improved tax collection have increased the absolute level of tax revenues, which is not only accounted for through favourable cyclical development. Dynamic economic growth has only partially contributed to increasing the revenue forecast. In view of slow price growth and a high foreign trade contribution, the acceleration of the nominal tax bases was slower than the acceleration of real economic growth. From the standpoint of general government revenues, the shift in growth dynamics from net export to domestic demand has a positive impact.⁷

Table 4.2: General government deficit by sub-sector

% of GDP	ESA code	Year 2002	Year 2003	Year 2004 (1)	Year 2005 (1)	Year 2006 (1)	Year 2007 (2)
Net lending/borrowing (EDP B.9) by sub-sectors							
General government	S.13	-6,8	-6,6	-2,9	-3,6	-3,5	-4,0
Central government	S.1311	-6,1	-6,0	-2,8	-3,6	-3,7	-3,8
Local government	S.1313	-0,5	-0,5	-0,1	-0,1	0,0	-0,2
Social security funds	S.1314	-0,2	-0,1	0,0	0,1	0,1	0,0

(1) Notifications (October 2006)

(2) Outlook

Source: Czech Statistical Office, Ministry of Finance

The overall development of the government deficit is affected considerably by the performance of central government institutions. The local government institutions operate with a constantly low deficit. In respect of their expenditure independence, the government is limited in the ways it can affect their performance. In principle, social security funds (health insurance companies) have recorded steady performance that is, nonetheless, achieved at the cost of transfers from the state budget and the purchase of unrecoverable receivables from health insurance companies by central government institutions. The social security funds sub-sector to some extent operates at the expense of the central government.

4.3 The Cyclically Adjusted Budget Balance and Fiscal Stance

During the timeframe of the CP, the Czech economy will be close to its potential. In 2006, a positive output gap was created that will gradually close from 2007 to 2009. Actual GDP will approach its potential, especially due to a reduction in the real GDP growth rate. Anticipated potential GDP growth should be driven mainly by total factor productivity.

With the anticipated closing of the positive output gap between 2006 and 2009, the cyclical component of the general government deficit will also be reduced. In 2008, a year-on-year decline of 0.6 of a percentage point can be expected in the absolute value of the cyclically adjusted balance, i.e. at a rate that does not interfere with the government's economic policies, and at the same time, that meets the requirements for developing a minimum level of fiscal effort as stipulated in the Stability and Growth Pact. To comply with the requirement of

⁷It is very difficult to clearly assess the impact of factors behind the increased tax collection. Between 2003 and 2005, there was also a change in the statutory tax rates, a change in the tax assignment, shifts in the tax structure, and the macroeconomic tax bases were repeatedly revised as a part of the major revisions of the Czech national accounts.

minimum fiscal effort in 2009, additional measures must be adopted for reducing the deficit against the approved outlook by a minimum of 0.1 to 0.2 of a percentage point of GDP.

Table 4.3: Cyclically adjusted balance^(a)

% of GDP	ESA code	Year 2005	Year 2006 (1)	Year 2007 (2)	Year 2008 (2)	Year 2009 (2)
1. Real GDP growth (%)		6,1	6,0	4,9	4,8	4,8
2. Net lending of general government	EDP B.9	-3,6	-3,5	-4,0	-3,5	-3,2
3. Interest expenditure (incl. FISIM)	EDP D.41	1,2	1,2	1,4	1,5	1,5
4. Potential GDP growth (%)		4,8	5,0	5,1	5,1	5,2
<i>contributions:</i>						
- labour		0,4	0,5	0,3	0,2	0,1
- capital		0,8	0,9	1,0	1,1	1,2
- total factor productivity		3,6	3,6	3,8	3,8	4,0
5. Output gap		-0,1	0,9	0,7	0,4	0,1
6. Cyclical budgetary component		0,0	0,3	0,2	0,1	0,0
7. Cyclically-adjusted balance (2 – 6)		-3,6	-3,8	-4,2	-3,6	-3,2
8. Cyclically-adjusted primary balance (7 – 3)		-2,5	-2,6	-2,8	-2,2	-1,7

(a) The data in rows 4 to 8 are based on the current estimates of the Ministry of Finance.

(1) Estimate

(2) Outlook

Source: Ministry of Finance

4.4 Government Debt

The ratio of general government debt to GDP reached 30.4% in 2005. This rate has been substantially revised in a downward direction since the last year's CP as a result of the decision on a change in the classification of a non-standard guarantee⁸. Only a gradual increase in the debt-to-GDP ratio can be expected up to 2009. Despite the existence of an excessive deficit, the government debt should only rise to 32.2% of GDP by 2009. On condition that the consolidation strategy for this year's CP is met and the estimated level of potential growth is sustained, the deficit should then drop below the level ensuring stabilisation of the share of government debt in GDP⁹.

The debt projection assumes a negative net accumulation of financial assets of around 4.7% of GDP from privatisation activities between 2005 and 2007. These revenues will be used to finance the deficit up to 2008. The second significant one-off factor affecting the government debt is that the Czech Consolidation Agency (CKA) will wind up its activities at the end of 2007. CKA anticipates the sale of the remaining assets and settlement of liabilities, which will gradually reduce its share in the general government debt from 1.5% of GDP in 2005 to 0.2% of GDP. The imputed state guarantees will eventually be settled from the state budget. The provision of new risk guarantees is not anticipated.

⁸ As a part of the notifications in April 2006, there was a decision made to exclude the maximum amount of the non-standard guarantee (CZK 160 billion, i.e. 6.2% of GDP) from the general government deficit and the debt for 2003. Thus, the Czech Statistical Office responded to Eurostat's statement from January 2006 that this guarantee should be excluded from the government deficit for 2003 and from the government debt for 2003 to 2005 (and as a conditioned obligation, from the balance sheets of government institutions as well).

⁹ With a nominal GDP growth rate between 7% and 8% per annum and a debt level of ca 32% of GDP, a deficit of ca 2.2% to 2.5% of GDP will stabilise the share of the debt in GDP.

4 General Government Finances – Deficit and Debt

Dynamic nominal GDP growth of 7.5% to 8.0% will help prevent any rise in the debt-to-GDP ratio. In view of the expected increase in interest rates, the contribution of interest payments to the change in debt will rise starting from 2007.

Table 4.4: Government debt – share by sub-sector

% of GDP	ESA code	Year 2005	Year 2006 (1)	Year 2007 (2)	Year 2008 (2)	Year 2009 (2)
Contributions to gross debt by sub-sectors						
General government	S.13	30,4	30,6	30,5	31,3	32,2
Central government	S.1311	27,8	27,8	27,8	28,6	29,6
<i>of which: CKA</i>		<i>1,5</i>	<i>0,6</i>	<i>0,2</i>	<i>-</i>	<i>-</i>
<i>state guarantees</i>		<i>2,6</i>	<i>1,7</i>	<i>1,2</i>	<i>1,0</i>	<i>0,9</i>
Local government	S.1313	2,6	2,8	2,7	2,7	2,7
Social security funds	S.1314	0,0	0,0	0,0	0,0	0,0

(1) Notifications (October 2006)

(2) Outlook

Source: Czech Statistical Office, Ministry of Finance

The outcome of the given factors in 2007 will be no change or a slight decline of around 0.1 of a percentage point in the share of debt in GDP. In 2008 and 2009, a rise in this share determined by the general government deficit and nominal GDP growth can be expected, with the diminishing impact of one-off factors in the form of the sale of financial assets. The projection, therefore, does not consider additional privatisation projects beyond 2007.

Table 4.5: Government debt and related indicators

% of GDP	Year 2005	Year 2006 (1)	Year 2007 (2)	Year 2008 (2)	Year 2009 (2)
Gross debt	30,4	30,6	30,5	31,3	32,2
Change in gross debt	-0,3	0,2	-0,1	0,8	0,9
Contributions to change in gross debt					
Primary balance	2,5	2,4	2,6	2,0	1,6
Interest expenditure (incl. FISIM)	1,2	1,2	1,4	1,5	1,5
Nominal GDP growth	-2,0	-2,2	-2,2	-2,2	-2,3
Stock-flow adjustment	-2,0	-1,1	-1,9	-0,5	0,0
- Difference between cash and accruals	-1,6	0,4	0,0	0,0	0,0
- Net accumulation of financial assets	-0,4	-1,5	-1,9	-0,5	0,0
of which: Privatisation proceeds	-3,6	-0,1	-1,0	0,0	0,0
- Valuation effects and other	0,0	0,0	0,0	0,0	0,0
p.m. implicit interest rate on debt	4,0	4,1	4,9	5,2	5,3

(1) Notifications (October 2006)

(2) Outlook

Source: Ministry of Finance