

## 4 General Government Finances – Deficit and Debt

### 4.1 The Strategy of the Government's Budget Policy

The Czech Republic continues to register excessive budgetary deficits, which are an obstacle on the way to fulfilling the Maastricht criteria. In its new programme declaration, the new government, formed in May 2005, asserted its strategy for reducing the budget deficits and its conscientious compliance with the Convergence Programme.

The public finance reform approved in 2003 and implemented in 2004 contained a set of measures geared to strengthening the income side and to achieving expenditure savings. In accordance with the adopted Conception of Public Finance Reform, the government continues to reduce the public finance deficit so that the consolidated public finance deficit does not exceed 3% of GDP in 2008.

Binding medium-term expenditure frameworks will continue to be an important pillar of the budget policy. These set the maximum volume of expenditures of the central government for a three-year period that corresponds to the established fiscal target. The expenditure frameworks can also help to identify the volume of savings needed to secure the target or to assess the government's success in reducing expenditures.

### 4.2 The Medium-Term Objective of Budgetary Policy

The Czech Republic will eliminate the excessive public budget deficit within the timeframe of the Convergence Programme. In 2008, the public budget deficit should fall safely below 3% of GDP. This step is the highest priority of all in the area of budgetary policy and government policy. The programme assumes a gradual reduction in the general government deficit to 3.8% of GDP in 2006, 3.3% in 2007 and 2.7% in 2008.

A tool for implementing the fiscal targets should be compliance with the binding expenditure frameworks. Successful compliance with these frameworks will promote expenditure-oriented fiscal consolidation. It will not be in conflict with the built-in stabilisers and will increase the transparency and credibility of the budget process.

**Table 4.1: Deficit by sub-sectors**

% of GDP	ESA code	Year 2004	Year 2005 (1)	Year 2006 (2)	Year 2007 (2)	Year 2008 (2)
<b>Net lending (B9) by sub-sectors</b>						
<b>General government</b>	<b>S.13</b>	<b>-3,0</b>	<b>-4,8</b>	<b>-3,8</b>	<b>-3,3</b>	<b>-2,7</b>
<b>Central government</b>	<b>S.1311</b>	<b>-3,0</b>	<b>-4,9</b>	<b>-3,5</b>	<b>-3,0</b>	<b>-2,4</b>
<b>Local government</b>	<b>S.1313</b>	<b>-0,1</b>	<b>-0,1</b>	<b>-0,3</b>	<b>-0,3</b>	<b>-0,3</b>
<b>Social security funds</b>	<b>S.1314</b>	<b>0,0</b>	<b>0,1</b>	<b>0,0</b>	<b>0,0</b>	<b>0,0</b>

(1) Estimate

(2) Trend values or period averages

Source: Ministry of Finance

Eliminating the excessive deficit is only the first step towards a medium-term objective consistent with the fiscal regulations of the European Union. The fiscal regulations of the Stability and Growth Pact promote the medium- and long-term focus for public budgets. The Czech Republic will make every effort to quickly reach such a medium-term public finance position. In reaching this goal, the 3% criterion of the Stability and Growth Pact will not be at risk during the cycle from the standard fluctuations of output around its potential level. Year-on-year cuts of 0.5 percentage points in the public budget deficit are seen to be an adequate and reasonable trajectory for reaching the medium-term target.

In accordance with the revised Stability and Growth Pact, the Czech Republic can be categorised as a country with a medium-term public budget deficit target of around 1% of GDP – in view of its above-average economic growth and relatively low level of public debt. The Czech Republic could attain this operative target by 2012. However, budgetary development over the long term will depend on the need to prepare for the process of an ageing population. The trajectory for the medium-term targets could only be disrupted by substantial structural reforms with direct budgetary costs, as could be the case for the pension system reform.

### 4.3 General Government Finances from 2004 to 2006

#### 2004

Last year's Convergence Programme anticipated a deficit of 5.2% of GDP in 2004, however, according to the latest estimates, the general government deficit was only 3.0% of GDP (CZK 83.5 billion). This development was supported by the legislative change in budgetary rules that allowed for the first time to carry over an unlimited amount for the under-executed budgetary allocations of government organisational units by transferring corresponding funds to their own reserves. This amounted to CZK 29 billion (ca 1.1% of GDP) and the reserves saved could be used for strengthening expenditures in upcoming years. These unexpected and sizeable carry-overs made it difficult to estimate the general government deficit. They had also created the potential for increasing the expenditures and deficit in 2005 above the government's budgetary plans.

The total tax revenues of the consolidated public budgets in 2004 exceeded the budgeted tax revenues by CZK 11.7 billion (0.4% of GDP). Higher tax revenues in combination with overall lower expenditures (as a result of under-executed budgetary allocations from the state budget headings) and reclassification of state guarantee<sup>7</sup> in favour of the CNB from 2004 to 1997 accountancy amounting to CZK 22.5 billion (0.8% of GDP) contributed to reducing the deficit from the planned 5.2% of GDP to 3.0% of GDP. Thanks to these extraordinary factors, general government finances finished in a substantially better position than in the original budgetary plans.

#### 2005

The previous Convergence Programme anticipated a deficit of 4.7% of GDP for 2005. The estimate of the deficit was changed to 5.0% of GDP in the March notifications. In the autumn notifications, the Ministry of Finance then estimated a deficit of CZK 140.5 billion (4.8% of

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<sup>7</sup> A Eurostat decision under the notification of the government debt and deficit dated March 2005

GDP). After adjusting the September government deficit estimate for extraordinary operations (see Box 4.1), which were included in last year's programme, the government deficit would be 1.1 percentage points lower, i.e. 3.7% of GDP. Economic growth accompanied by an increase in tax revenues and slower execution of budgetary expenditures has a positive effect on the budget deficit, which creates space for better deficit outcome than originally targeted..

### Box 4.1: Extraordinary public budget operations in 2005<sup>8</sup>

- Recording unrecoverable receivables in Syria amounting to CZK 18.7 billion (0.6% of GDP)
- Supplying military technology for the army as a form of payment on the Russian debt increased the general government deficit by CZK 3.3 billion (0.1% of GDP).
- A change in the accounting for recording the lease of Grippen aircraft, when, after the March government deficit and debt notifications, it was definitely decided to fully record this operation in 2005. As a result, the deficit had increased by CZK 9.6 billion (0.3% of GDP).

Favourable tax performance is influenced in particular by corporate income taxes and excise tax revenues (increasing the excise tax rates on tobacco and improving the administration of excise taxes). Higher-than-budgeted corporate income tax revenues are the result of accelerated economic growth and positive developments for the profits of large corporations. A rise in excise tax revenues is connected with an increase in the transport of goods across the Czech Republic. The anticipated rise in tax collections against planned revenues amounts to approximately CZK 25.5 billion (0.9% of GDP). The estimate of the 2005 tax revenues was complicated by the comprehensive changes in the structure of taxation, the impact of which can be difficult to quantify with adequate precision.

The rise in tax revenues cannot be explained by the economy's cyclical development. During the past two years, tax revenues have structurally increased, and there are two reasons for this. The first reason relates to the fact that the estimate of potential GDP growth was significantly increased. The second reason involves the change in the structure of taxes relating to the range of measures adopted in the public finance reform (see Convergence Programme, November 2004) that increased the overall level of tax revenues above the budgetary plan.

In connection with the 2004 carry-overs, there was a risk on the expenditure side that the expenditure plan for 2005 would be exceeded. The budget headings carried over CZK 24.9 billion to 2005 that could be used for additional expenses. However, the fiscal performance of the state budget shows that the budget headings will not increase their expenditures above the approved 2005 budget. The creation of reserve funds in an expected amount of CZK 20.3 billion will then correspond approximately to the carry-overs from 2004, and the impact on the balance in 2005 will be almost neutral (CZK 4.6 billion, i.e. 0.15% of GDP).

The execution of state budget expenditures for the first three quarters of this year reached about 68.5% of the full year budget, which corresponds more or less to the level drawn down last year. A lower volume of drawn resources is registered, in particular, by debt service. Mixed developments were recorded in the area of social benefits. On the one hand, a lower volume of benefits was executed for government social support benefits and other social

<sup>8</sup> See the conclusions of Eurostat's EDP mission, August 2005.

benefits. The savings in this area, however, are offset by higher than budget expenditures for pensions, sickness benefits and social welfare benefits.

### 2006

The planned public budget deficit for 2006 is 3.8% of GDP. This estimate is based on the continued dynamic growth of the Czech economy. The very favourable structural development of tax revenues supports the consolidation of public budgets and helps to reduce the general government deficit.

In 2006 as well, the Ministry of Finance anticipates a continuation of favourable tax revenue development. The effect of the higher tax base from 2005 will show up, and the autonomous development of taxes will substantially exceed the volume of taxes predicted last year during preparation of the medium-term fiscal framework. In view of the prepared legislative changes for personal income tax (a rate reduction, extending the tax brackets and replacing the deductible entries with tax credits), a reduction in direct taxes can be expected. The compound tax quota should, therefore, decrease after reflecting the active measures.

The structural increase in tax revenues helped to meet the fiscal targets. This development weakened the need of substantial expenditure savings in an election year. The Czech Republic will be capable of fulfilling the objective of the Convergence Programme despite the fact that certain expenditure savings were not implemented. It was not politically feasible to implement all of the expenditure measures proposed by the Ministry of Finance in the previous programme (reducing expenditures for social welfare benefits and state social support, freezing the wages of court officials, judges and members of parliament, and an overall restriction of budget heading expenditures).<sup>9</sup>

Exceeding the expenditure framework of the central government is expected in the draft state budget for 2006 against the expenditure framework approved by the resolution of the Chamber of Deputies. The expenditure framework of the central government was increased by CZK 24.3 billion (0.8% of GDP). However, thanks to higher expected tax collection, the general government deficit that the Czech Republic committed itself to will not be exceeded.

This increase allowed the government to achieve higher valorisation of pensions above the framework considered in the conception of public finance reform. In the area of state social support, an increase in benefits is expected in relation to the planned increase in the minimum subsistence level. The government also plans to increase social benefits paid out to families with children in response to a recovery in the Czech Republic's birth rate. These measures will lead to an increase in the share of mandatory social expenditures. More resources are also expected for active employment policy, employing disabled persons and environmental protection.

In 2006, downscaling of the number of employees in the central government will continue. Out of approximately 29,000 positions to be eliminated between 2004 and 2006, 13.2% of this total amount will occur during 2006. The number of positions will decline by 3,900 positions

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<sup>9</sup> *Convergence Programme of the Czech Republic, autumn 2004, p. 42, table 6.2 – Additional Savings Measures Suggested by the Ministry of Finance*

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against 2005 (i.e. by 0.83%).<sup>10</sup> With respect to the overall plan for downscaling the number of positions, a reduction of 16,600 will occur, i.e. about 56% of the planned change.

**Table 4.2: General government deficit and debt, by sub-sector**

% of GDP	ESA code	Year 2001	Year 2002	Year 2003	Year 2004 (1)	Year 2005 (1)	Year 2006 (2)
<b>Net lending (EDP B9) by sub-sectors</b>							
<b>General government</b>	<b>S.13</b>	<b>-5,9</b>	<b>-6,8</b>	<b>-12,0</b>	<b>-3,0</b>	<b>-4,8</b>	<b>-3,8</b>
<b>Central government</b>	<b>S.1311</b>	<b>-5,6</b>	<b>-6,3</b>	<b>-11,6</b>	<b>-3,0</b>	<b>-4,9</b>	<b>-3,5</b>
<b>Local government</b>	<b>S.1313</b>	<b>-0,3</b>	<b>-0,2</b>	<b>-0,3</b>	<b>-0,1</b>	<b>-0,1</b>	<b>-0,3</b>
<b>Social security funds</b>	<b>S.1314</b>	<b>0,0</b>	<b>-0,2</b>	<b>-0,1</b>	<b>0,0</b>	<b>0,1</b>	<b>0,0</b>

(1) Notification (September 2005)

(2) Trend values or period averages

Source: Czech Ministry of Finance

### 4.4 The Cyclically Adjusted Budget Balance and Fiscal Stance

During the timeframe of the Convergence Programme, the Czech economy will be close to its potential. The output gap will be slightly positive in 2005 and 2006. A decline in actual GDP below the potential is already assumed in 2008 as a result of acceleration of the potential GDP growth rate. According to expectations, potential growth will be driven by total factor productivity.

The cyclical component of public budgets is very low due to the low absolute value of the output gap from 2005 to 2008. The level of fiscal restriction can be explained the best by a change in the cyclically adjusted primary balance that isolates the effect of an expected rise in interest payments. The decline in the cyclically adjusted primary balance will be on average 0.8 of a percentage point per annum between 2005 and 2008, which can be seen as an adequate tempo that does not conflict with the government's efforts to sustain robust economic growth.

<sup>10</sup>After offsetting the transfer of the regional school councils. These were transferred during 2005 and incorporated once again into the central government in 2006.

Table 4.3: Cyclically adjusted balance <sup>(a)</sup>

% of GDP	ESA code	Year 2004	Year 2005 (1)	Year 2006 (2)	Year 2007 (2)	Year 2008 (2)
<b>1. Real GDP growth (%)</b>		4,4	4,8	4,4	4,2	4,3
<b>2. Net lending of general government</b>	<b>EDP B.9</b>	-3,0	-4,8	-3,8	-3,3	-2,7
<b>3. Interest expenditure (incl. FISIM)</b>	<b>EDP D.41</b>	1,3	1,3	1,3	1,3	1,4
<b>4. Potential GDP growth (%)</b>		3,6	4,3	4,3	4,3	4,5
<i>contributions:</i>						
- labour		0,0	0,2	0,1	0,1	0,1
- capital		1,1	1,2	1,1	1,1	1,2
- total factor productivity		2,5	2,9	3,1	3,1	3,1
<b>5. Output gap</b>		-0,4	0,1	0,1	0,0	-0,2
<b>6. Cyclical budgetary component</b>		-0,1	0,0	0,0	0,0	0,0
<b>7. Cyclically-adjusted balance (2 – 6)</b>		-3,0	-4,8	-3,8	-3,3	-2,7
<b>8. Cyclically-adjusted primary balance (7 – 3)</b>		-1,7	-3,5	-2,5	-2,0	-1,2

(a) Member states can complete rows 4 to 8 using their own figures or the Commission's figures.

(1) Estimate

(2) Trend values or period averages

Source: Ministry of Finance

## 4.5 Government Debt

At the end of 2004, the general government debt reached 36.8% of GDP. The medium-term fiscal framework assumes only a slight increase in the debt-to-GDP ratio. By the end of 2008, an increase of one percentage point in the government debt is expected against 2004. Hence, the general government debt will increase to 37.8% of GDP in 2008. With current nominal GDP growth, a deficit level that ensures stabilisation of the share of government debt in GDP should be attained in 2008.<sup>11</sup>

The debt projection is based on the assumption that the Czech Consolidation Agency (CKA) will wind up its activities by 2007, and with a reduction in the balance sheet, the volume of its liabilities will also decline. Another assumption is that the government will no longer provide additional risk guarantees. Government guarantees and CKA's accumulated loss will be progressively covered by the state budget. CKA's debt will be reduced from 3.3% to 0% of GDP, and the volume of imputed state guarantees will decrease from 9.2% to 5.4% of GDP. In this way, CKA's liabilities and the imputed state guarantees will be gradually transformed into tradable debt instruments.

<sup>11</sup> With a nominal GDP growth rate of ca 7% per annum and a debt level of ca 38% of GDP, a deficit of ca 2.5% to 3.0% of GDP will stabilise the share of the debt in GDP.

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**Table 4.4: Government debt – share by sub-sector**

% of GDP	ESA code	Year	Year	Year	Year	Year
		2004	2005 (1)	2006 (2)	2007 (2)	2008 (2)
<b>Gross debt by sub-sectors</b>						
<b>General government</b>	<b>S13</b>	<b>36,8</b>	<b>37,4</b>	<b>37,1</b>	<b>37,9</b>	<b>37,8</b>
<b>Central government</b>	<b>S1311</b>	<b>34,2</b>	<b>34,6</b>	<b>34,3</b>	<b>35,0</b>	<b>34,8</b>
<i>of which: CKA</i>		3,3	1,6	1,0	0,2	0,0
<i>state guarantees</i>		9,2	8,2	7,5	6,0	5,4
<b>Local government</b>	<b>S1313</b>	<b>2,6</b>	<b>2,8</b>	<b>2,8</b>	<b>2,9</b>	<b>2,9</b>
<b>Social security funds</b>	<b>S1314</b>	<b>0,0</b>	<b>0,0</b>	<b>0,0</b>	<b>0,0</b>	<b>0,0</b>

(1) Estimate

(2) Trend value or period averages

Source: Ministry of Finance

The growth dynamics of the government debt will gradually diminish after 2005. Nominal GDP growth of 6.0% to 7.5% annually will contribute every year to reducing the debt level by about 2.0 to 2.5 percentage points and thus will offset a substantial part of debt growth due to ongoing deficits. The deficit's contribution to debt accumulation will be reduced over time with gradual fiscal consolidation. In 2005, high revenues from privatisation will contribute to a decline in the debt to 3.5% of GDP. These revenues will not be used entirely to cover the debt in this year, and a certain amount will be available to finance the deficits in 2006 as well. For this reason, we anticipate a decline next year in the share of the government's debt in GDP. In 2007 and 2008, debt dynamics are almost entirely determined by the general government deficit and nominal GDP growth.

**Table 4.5: Government debt and related indicators**

% of GDP	Year	Year	Year	Year	Year
	2004	2005 (1)	2006 (2)	2007 (2)	2008 (2)
<b>Gross debt</b>	36,8	37,4	37,1	37,9	37,8
<b>Change in gross debt</b>	0,0	0,6	-0,3	0,8	-0,1
<b>Contributions to change in gross debt</b>					
<b>Primary balance</b>	1,8	3,5	2,5	2,0	1,2
<b>Interest expenditure (incl. FISIM)</b>	1,3	1,3	1,3	1,3	1,5
<b>Nominal GDP growth</b>	-2,6	-2,0	-2,3	-2,4	-2,6
<b>Stock-flow adjustment</b>	-0,5	-2,3	-1,8	-0,1	-0,2
- Difference between cash and accruals	-0,2	-0,5	-0,1	0,0	0,0
- Net accumulation of financial assets	-0,6	-3,5	0,0	0,0	0,0
<i>of which: Privatisation proceeds</i>	-0,6	-3,5	0,0	0,0	0,0
- Valuation effects and other	0,3	1,8	-1,7	-0,1	-0,1
<b>p.m. implicit interest rate on debt</b>	3,7	3,7	3,8	3,9	4,1

(1) Estimate

(2) Trend values or period averages

Note: The difference between the cash and accrual approach is approximated by the difference between the balance using the national methodology, which is based on the cash principle and more closely correlates to debt development, and the balance using the ESA 95 methodology. Net accumulation of financial assets only contains the decline in assets as a result of privatisation. "Overvaluation and other factors" is a residual term.

Source: Ministry of Finance

As for administering government obligations and drafting a medium-term strategy for financing the central government, the primary focus is on the indebted segments of the

general government whose financial security is under the direct responsibility of the Ministry of Finance. The state debt (23.7% of GDP) is the main balance sheet entry of these government obligations. Moreover, this involves obligations arising from covering CKA's expected financial needs from 2006 to 2008 (1.2% of GDP) and risky state guarantees (8.2% of GDP) that, represent for the expenditure side of the state budget a financial risk analogous to the debt structure.

Starting in 2005, the integrated administration of the given three segments was implemented in respect to costs and risks and to planning the strategy of financing and issue activities. In 2006, this portfolio integration should also include state financial assets excluding foreign receivables (6.8% of GDP) allowing for further improvements in the administration of a wider government financial balance.

### Managing refinance risk

In relation to its decision to launch regular issues on the foreign market, the Ministry of Finance announced in the first half of 2004 a gradual three-year trajectory for a decline in the share of short-term government debt (with a maturity of one year). The following targets were set for 2004 to 2006: 25% to 30% for 2004, 22.5% to 27.5% for 2005 and 20% to 25% for 2006. By the end of 2004, a value of 25% was reached, exactly at the lower limit of the announced band, which helped to speed up the process of reducing the short-term debt. A target of 24% or less was announced for 2005, and starting at the end of 2006, a target of 20% or less. By the end of 2005, we anticipate a value of around 22%, i.e. meeting the target for this year. By the end of 2006, the ministry should reach the final planned and long-term targeted limit of 20%, which starting from 2007, will become one of the most fundamental limits of risk management in upcoming years.

Another indicator used during refinance risk management is the average period to maturity for the government debt. In December 2004, the ministry announced a target of 5.5 to 6.5 years for the first time in the Strategy for Financing and Management of the State Debt. By the end of this year, a value of around 5.8 years is expected. The Ministry of Finance will continue in its policy of extending the maturity of the state debt in the medium-term horizon as well.

### Managing interest rate risk

Interest rate risk remains the most important market risk in managing the state debt. In respect to launching interest rate risk management through financial derivatives, the ministry introduced in 2002 annual targeting of the modified duration of the state debt. This newly defined target, including the effect of financial derivatives, was set at 3.8 years  $\pm$  0.4 of a year for 2005. Against 2004 (with a target of 3.3 to 4.3 years), the midpoint target value of duration was sustained while narrowing the band by 0.2 of a year. The ministry does not plan to make any additional increases of a more significant nature in the modified duration during the medium-term horizon, however, as in this year, it will attempt to stabilise it in a narrower band.

The current exposure vis-à-vis a change in interest rates up to one year generated by the structure of the government debt (after including derivative operations), i.e. interest rate refixing up to one year, will be stabilised under 30% starting from the end of Q3 2004.



**Table 4.6: Government debt from the standpoint of interest**

in %	Year 2002	Year 2003	Year 2004	Year 09/2005
<b>1. Fixed interest rate long-term debt</b>	<b>57,1</b>	<b>64,7</b>	<b>75,2</b>	<b>76,3</b>
1a. <i>Of which: due in 1 year or less</i>	7,2	7,9	3,7	4,5
<b>2. Variable interest rate long-term debt</b>	<b>1,1</b>	<b>2,4</b>	<b>3,5</b>	<b>8,8</b>
<b>3. T-bills</b>	<b>41,4</b>	<b>32,6</b>	<b>21,2</b>	<b>14,8</b>
<b>4. Non interest bearing debt</b>	<b>0,4</b>	<b>0,3</b>	<b>0,1</b>	<b>0,1</b>
1a. <i>Of which: due in 1 year or less</i>	0,3	0,3	0,1	0,1
<b>5. Debt subject to IR re-fixing within 1 year (1a + 2 + 3 + 4a)</b>	<b>50,0</b>	<b>43,2</b>	<b>28,5</b>	<b>28,2</b>
<b>6. Including effect of interest rate swaps</b>	<b>36,8</b>	<b>36,4</b>	<b>27,0</b>	<b>27,9</b>

*Note: The figures in the table include the impact of currency and interest rate derivative operations. The effect of the portfolio derivatives that are not connected to specific debt instruments is given in line 6.*

Source: Ministry of Finance

The interest rate sensitivity of the debt portfolio, including derivative operations expressed using modified duration is expected to be in a range of 3.9 to 4 years by the end of 2005 and is situated within the announced targeted band. It can be inferred from the amount of the government debt and its structure from the standpoint of interest that increasing interest rates by one percentage point would increase interest rate payments by about CZK 1.8 billion (0.1% of GDP) within a one-year period when accounting for the effect of derivative operations.

### Managing currency risk

The exchange rate exposure of the government debt remains at a negligible level of 0.07% even at the end of the year.<sup>12</sup> The Eurobond issues in 2004 and 2005 were hedged against exchange rate risk by agreement between the Governor of the CNB and the Minister of Finance. The potential market appreciation impact of the single conversion of the issue proceeds of EUR 1.5 billion or EUR 1 billion, respectively, to CZK was also eliminated in this fashion. Higher currency exposure is present in the structure of risky state guarantees (ca 28%).

### The risk profile of the state guarantee portfolio

From the standpoint of managing the market risk of the expenditure side of the state budget, not only the structure of the state debt is relevant, but also the structure of the portfolio of state guarantees provided for loans for which the state budget covers principal instalments and interest payments. The Ministry of Finance thus began integrated monitoring of the portfolio of the state debt and risky state guarantees. As a part of managing the government debt, regular monitoring of the state guarantee portfolio was introduced in connection with the strategic goals of the government's debt policy and the ministry's risk management.

<sup>12</sup> This involves USD bills of exchange issued for the Czech Republic's participation in the EBRD and around EUR 12 million for the principal on Eurobonds from 2005, which remained unhedged against currency risk..

**Table 4.7: Risk profile of the government debt, including state guarantees (end of September 2005)**

	Volume	Foreign currency	Variable interest rate	Due in one year	Average maturity	Modified duration
	bil CZK	%	%	%	years	years
State debt	662,6	0,1	4,3	19,4	5,8	3,9
Analyzed state guarantees	95,6	27,9	23,1	27,4	3,9	2,3
<b>Total portfolio</b>	<b>758,2</b>	<b>3,6</b>	<b>6,7</b>	<b>21,4</b>	<b>5,6</b>	<b>3,7</b>

Source: Ministry of Finance

Integrated management of government obligations proved to be effective during the first year of implementation, and over time, it should also lead to further expansion in the direction of integrating the structure of government obligations with the portfolio of government financial assets.

## 4.6 The Budget Consequences of Important Structural Reforms

The government submitted a package of social legislation to the Chamber of Deputies this year that, if adopted, should strengthen motivation for labour activities and more efforts towards changing the social and economic situation. The changes reinforce the already approved measures in the previous Convergence Programmes (limiting the amount of sickness benefits and state welfare benefits, permitting a combination of proceeds and collection of parental contributions, and entitlement to social benefits conditioned by the duty to accept eight hours of public service work per month).

The newly proposed changes are related to the following areas:

- Minimum subsistence level
- Sickness insurance
- Poverty relief
- Social services
- Social security.

As for the minimum subsistence level and poverty relief, efforts are being made to set the system of social benefits so that citizens are actually motivated to work. The aim is to sufficiently and justly protect citizens from poverty, as well as motivate them to actively seek employment and to even accept lower paid jobs benefiting those who try to increase their income through their own efforts.

### Box 4.2: Planned changes in social security

The newly introduced **minimum subsistence level** will be a one-component system. The minimum subsistence amounts needed for securing food and other basic needs will be categorised according to the rank of people in a household, and for unaided children, according to age. The change in the structure of the minimum subsistence level will also affect the amount of government welfare benefits. The amounts expressing the costs of living should be eliminated from minimum subsistence, and housing needs will be resolved in the government welfare system provided by the newly created housing contribution and in the poverty relief system with a housing allowance. The reason behind this step is the substantial differences in housing costs.

In addition, the principle of **reduced subsistence minimum** will be introduced. This will express the costs of the minimum living standards necessary for survival. The reduced subsistence minimum level will guarantee a certain minimum standard of living for poverty-stricken individuals who are not entitled to minimum subsistence support, and in view of their lack of effort to increase their own income, they will receive assistance only at the level of reduced subsistence minimum. The goal of these changes in poverty relief assistance is to prevent long-term dependency on social benefits and to give preferential treatment to recipients of benefits who are active in resolving their own situation.

With respect to **sickness benefits**, wages compensation should be paid by the employer during the first two weeks of work sickness. However, this measure should also be compensated by lowering the premium rate for the employer by 1.9 percentage points (from 3.3% to 1.4%). A positive effect will be associated in particular with preventing rising costs as a result of the increasing occurrence of short-term illnesses. This will no longer affect the sickness insurance system but rather the employer's financial results. With this shift of sickness payments onto the employer, a reduction of CZK 9.2 billion in the state budget expenditures is expected in 2007 and CZK 10.3 billion in 2008. However, the net impact of changes in the area of sickness insurance (after adjusting for the decrease in premiums) will be negative, i.e. CZK –10.7 billion in 2007 and CZK –10.9 billion in 2008.

As a part of the social package, there will also be a change in the payment structure of certain benefits. A fundamental change relates, in particular, to the Social Security Act. With regard to introducing a **care allowance**, the increase in pension for dependent individuals and the care allowance for next of kin or another person will be cancelled. The aim of the care allowance is to aid persons who are dependent on the assistance of other persons and on essential aid from welfare services in particular, due to their adverse social situation. Entitlement to this allowance is based on a system of personal assessment of an individual's ability to care for themselves and their self-sufficiency. The allowance amount is set individually according to the age of the assessed person and to a person's level of dependency on the assistance of others in adverse social situations.

Moreover, a **new definition of the assessment base** is proposed for the state's payment into public health insurance for state-insured individuals (children, pensioners, unemployed, etc.) with the aim of securing its regular valorisation. Although this increases the state budget deficit, it also strengthens the resources of public health insurance. So a negative effect would occur if more resources were used to increase healthcare expenditures.

An adjustment in the premium for social security is anticipated with an amendment to the Act on Sickness Insurance introducing a **maximum assessment** base for employees as well as an adjustment in the maximum assessment base for self-employed persons. A maximum employee assessment base of sixty times the average wage for paying the premium is proposed in 2007, in 2008 forty eight times the average wage, and starting in 2009 thirty six times the average wage. The assessment base of self-employed persons will also be adjusted in a similar fashion<sup>13</sup>. The overall estimated impact of these changes is CZK –22.4 billion in 2006 and CZK –24.2 billion in 2007.

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<sup>13</sup> *The proposed maximum assessment base for self-employed persons for the pension insurance premium and the contribution to the government employment policy is CZK 486,000 prior to 2007, sixty times the average wage in 2007, forty eight times the average wage in 2008, and starting from 2009 thirty six times the average wage. These amounts are reduced by CZK 40,500 prior to 2007, by five times the average wage in 2007, by four times the average wage in 2008 and by three times the average wage starting in 2009.*

**Table 4.8: Impact of the proposed social legislation**

Billion CZK	Year 2007	Year 2008
<b>Impact on revenues</b>		
New Act on Sickness Insurance	-19,9	-21,2
Adjustments in the assesment base	-2,5	-3,0
<b>Overall impact on social contributions</b>	<b>-22,4</b>	<b>-24,2</b>
<b>Impact on expenditures</b>		
New Act on Sickness Insurance	-9,2	-10,3
Social welfare changes due to new subsistence level	3,6	3,9
New poverty relief benefits	10,0	10,5
Abolishment of social need benefits	-6,4	-6,4
Contribution to placement in healthcare facilities	1,2	2,0
Welfare contribution (new Social Services Act)	8,0	8,3
Abolishment of the increase in pension for dependent individuals and the welfare contribution for next of kin or another person	-3,7	-3,8
Newly defined assessment base for the state's contribution to public health insurance	3,1	3,9
<b>Overall impact on social expenditures</b>	<b>6,6</b>	<b>8,1</b>

Source: Ministry of Finance

These measures strengthen the motivation for active participation in the labour market and prevents abuse of the social system. The higher demands on citizens will be offset by a rise in expenditures in the social sphere. The overall expenditure impact of all proposed measures in the social package is negative and amounts to CZK 29 billion in 2007 and CZK 32.3 billion in 2008.

This package is being deliberated at this time by the Chamber of Deputies. Approval of the package in its current form would have significant budgetary consequences and presents a risk for meeting the fiscal targets up to 2008. As the government has passed the binding expenditure ceilings for 2007 and 2008, it will be necessary to offset the budgetary effects of the proposed changes by savings in other areas.