

3 General Government Deficit and Debt

3.1 The Government's Strategy and the Medium-Term Fiscal Targets

The main objectives of the government in the area of fiscal policy (see Section 1), which will be reflected in the general government finances in the medium-term horizon, are reducing the general government deficit towards the medium-term budgetary objective, lowering the dynamics of overall government expenditures, limiting the share of mandatory expenditures and a slow reduction in the tax burden.

In contrast with the previous CP update, the government has set more ambitious fiscal targets for the general government deficit of 3.0% of GDP in 2008, 2.6% in 2009, and 2.3% in 2010. In addition, more strict expenditure ceilings for the state budget and state funds have been approved, which should ensure that the set targets are reached.

On the expenditure side, the government has agreed to extensive budgetary savings in the area of mandatory social expenditures and wages and salaries. In contrast, expenditures especially of an investment character have been partially strengthened. Hence, the volume of the medium-term expenditure ceilings will be reduced by 0.4% of GDP in 2008 and 0.9% of GDP in 2009.

Limiting the dynamics of government expenditures allows a slow reduction in the tax burden, relating especially to the taxation of labour and legal entities. A reduction in direct taxation will be more than fully offset in 2008 and partially offset in the years to follow by increases in value added tax, excise taxes and by introducing environmental taxes.

The stabilisation budget measures that were passed in the first phase of the planned structural reforms should ensure the sustainable elimination of the excessive deficit by 2008 at the latest.

The current settings of fiscal policy do not ensure that the medium-term budgetary objective will be reached by 2012. Meeting this deadline will require the adoption of additional budgetary measures. The second phase of reforms, which should also resolve the long-term sustainability of public finances, will be the subject of political discussions in 2008.

3.2 Current Development of Public Finances

General government institutions have registered a deficit. From 2004 to 2006, however, the sector had performed better than was originally expected. This was, on the one hand, the result of higher-than-expected revenues due to the partially cyclical and partially structural increase in tax collection. On the other hand, the lower level of expenditures had caused a reduction in the deficit as a result of the newly introduced possibility of transferring unlimited amounts of unused budgetary funds to future years. During these three years, funds totalling 2.1% of GDP were transferred to the reserve funds in this manner.

Table 3.1: General government deficit by sub-sector

% of GDP	ESA code	Year 2002	Year 2003	Year 2004	Year 2005	Year 2006	Year 2007 (1)
Net lending (+)/borrowing (-) (EDP B.9) by sub-sectors							
General government	S.13	-6.8	-6.6	-3.0	-3.5	-2.9	-3.4
Central government	S.1311	-6.1	-6.0	-2.7	-3.5	-2.8	-3.5
Local government	S.1313	-0.5	-0.5	-0.2	-0.1	-0.5	-0.2
Social security funds	S.1314	-0.2	-0.1	-0.1	0.0	0.4	0.3

(1) Notifications (October 2007)

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

General government finances in 2007 are encumbered by a high increase in social expenditures as a result of changes in the social legislation approved prior to the parliamentary elections in 2006. These changes contribute to a rise in the deficit of around 1.0 percentage point of GDP in 2007.

The general government balance will reach a figure of about -3.4% of GDP, which is an improvement of 0.6 of a percentage point over the estimate from last year's CP update. The change in the estimate has been mainly caused by higher-than-expected revenues from taxes and social contributions as a result of the continued economic boom. However, the original fiscal target of -3.3% of GDP will probably not be reached.

One risk for the economic results in 2007 is the possibility of using more resources from the reserve funds. In view of tightening the conditions for disposing of these funds (see Section 7), the budget headings are more motivated to use these funds, which in turn, may increase government expenditures.

3.3 The Medium-Term Fiscal Outlook

The budget for 2008

The state budget for 2008 is formulated in such a way that the general government deficit is reduced to under 3% of GDP. The planned deficit, according to the national method of fiscal targeting, is 2.5% of GDP. Considering that the expected deficit using the ESA 95 methodology should exceed the national fiscal target by a maximum of 0.4 of a percentage point according to current estimates, a reserve for eliminating the excessive deficit has already been created for 2008.

The general government balance in 2008 is estimated to be -2.9% of GDP in 2008, i.e. 0.1 of a percentage point better than the set fiscal target. Moreover, the balance of risks points to a lower deficit. The prediction of tax revenues can be assessed as conservative on the basis of the latest information on tax collection and macroeconomic development. In comparison with past performance, the assumption on the deficit for general government institutions, not relating to expenditure frameworks and health insurance companies, has also been set in a relatively conservative manner.

Table 3.2: General government deficit by sub-sector

% of GDP	ESA code	Year 2006	Year 2007 (1)	Year 2008 (2)	Year 2009 (2)	Year 2010 (2)
Net lending (+)/borrowing (-) (EDP B.9) by sub-sectors						
General government	S.13	-2.9	-3.4	-2.9	-2.6	-2.3
Central government	S.1311	-2.8	-3.5	-2.9	-2.5	-2.2
Local government	S.1313	-0.5	-0.2	-0.1	-0.1	-0.1
Social security funds	S.1314	0.4	0.3	0.0	0.0	0.0

(1) Notifications (October 2007)

(2) Outlook

Source: Czech Statistical Office (2006), Ministry of Finance

Outlook for 2009 and 2010

The budgetary outlook for 2009 and 2010 anticipates another gradual reduction in the government deficit. The pace of fiscal consolidation approximately corresponds to the objectives presented in last year's CP. The budgetary measures passed during last year focused, in particular, on a return to the original trajectory and elimination of the excessive deficit in the originally planned term of 2008. Hence, the largest fiscal effort is concentrated in the period up to 2008.

A slower decline in the deficit for upcoming years stems from the fact that the expected overall positive impact of reform measures in the area of social benefits and taxes decreases over time. The deficit reduction in 2009 and 2010 is, therefore, secured through savings in other expenditures, especially for defence and wages and salaries. An acceleration in the rate of reducing the deficit is conditioned by continued reform measures in future years as well.

3.4 The Structural Balance and the Fiscal Stance

According to current estimates, the Czech economy has reached the peak of its economic cycle. Real GDP will approach its potential from 2008 to 2010 due to slowing of real GDP growth to a level below potential growth. This will show up as a gradual closing of the positive output gap and a reduction in the cyclical component of the general government balance.

Fiscal effort in the form of a year-on-year change in the structural balance is the highest in 2008, at which time it will reach a value of 0.6 of a percentage point of GDP. From 2009 to 2010, the estimated fiscal effort will reach 0.4 of a percentage point of GDP. To meet the requirement of minimum fiscal effort during these two years, it will be necessary to accept additional measures for accelerating the decline in the deficit by a minimum of 0.1% of GDP each year.

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Table 3.3: Structural balance^(a)

% of GDP	ESA code	Year 2006	Year 2007 (1)	Year 2008 (2)	Year 2009 (2)	Year 2010 (2)
1. Real GDP growth (%)		6.4	5.9	5.0	5.1	5.3
2. Net lending of general government	EDP B.9	-2.9	-3.4	-2.9	-2.6	-2.3
3. Interest expenditure	EDP D.41	1.1	1.2	1.3	1.2	1.2
4. One-off and other temporary measures		-0.2	0.0	0.0	0.0	0.0
5. Potential GDP growth (%)		5.3	5.2	5.5	5.6	5.7
<i>contributions:</i>						
- total factor productivity		4.1	4.2	4.2	4.2	4.5
- labour		0.3	0.0	0.1	0.1	0.0
- capital		0.9	1.0	1.1	1.2	1.3
6. Output gap		0.7	1.3	0.9	0.4	0.0
7. Cyclical budgetary component		0.2	0.3	0.2	0.1	0.0
8. Cyclically-adjusted balance (2 – 7)		-3.2	-3.8	-3.2	-2.7	-2.3
9. Cyclically-adjusted primary balance (8 + 3)		-2.1	-2.6	-1.9	-1.5	-1.1
10. Structural balance (8 – 4)		-3.0	-3.7	-3.1	-2.7	-2.3

(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

3.5 Government Debt

The outlook for the government debt has improved over last year's CP update under the influence of a lower-than-expected deficit in 2006 and due to a reduction in the expected resources needed to finance the deficit between 2007 and 2010.

Table 3.4: Government debt by sub-sector

% of GDP	ESA code	Year 2006	Year 2007 (1)	Year 2008 (2)	Year 2009 (2)	Year 2010 (2)
Gross debt by sub-sectors						
General government	S.13	30.1	30.4	30.3	30.2	30.0
Central government	S.1311	27.6	27.8	27.9	27.9	27.7
Local government	S.1313	2.7	2.6	2.5	2.4	2.4
Social security funds	S.1314	0.0	0.0	0.0	0.0	0.0

(1) Notifications (October 2007)

(2) Outlook

Source: Czech Statistical Office (2006), Ministry of Finance

In view of relatively rapid economic growth, the government deficit should approach a level stabilising the share of debt in GDP during the outlook horizon.

The government debt is increasing at a slower pace than would correspond to absolute deficit accumulation. Besides debt instruments, the deficits are financed through the sale of financial assets, especially as a part of privatisation. Thus, deficit performance is also partially reflected in an increase in the general government's debt liabilities, and to a certain degree, also in a reduction of the volume of financial assets with no impact on the debt. Drawing on unused financial resources acquired through privatisation for government expenditures will help

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prevent increases in the government debt in future years as well (see the negative value of the item “Net accumulation of financial assets”).

Table 3.5: Government debt and related indicators

% of GDP	Year 2006	Year 2007 (1)	Year 2008 (2)	Year 2009 (2)	Year 2010 (2)
Gross debt	30.1	30.4	30.3	30.2	30.0
Change in gross debt ratio	-0.1	0.2	0.0	-0.1	-0.2
Contributions to change in gross debt					
Primary balance	1.8	2.3	1.7	1.3	1.1
Interest expenditure	1.1	1.2	1.3	1.2	1.2
Nominal GDP growth	-2.3	-2.5	-2.3	-2.1	-2.1
Stock-flow adjustment	-0.8	-0.7	-0.6	-0.6	-0.3
- Difference between cash and accruals	0.0	0.0	-0.3	-0.2	0.0
- Net accumulation of financial assets	-0.8	-0.7	-0.4	-0.3	-0.3
of which: privatisation proceeds ⁽³⁾	0.1	0.9	0.0	0.0	0.0
- Revaluation effects and other	0.0	0.0	0.0	0.0	0.0
p.m. implicit interest rate on debt	3.6	3.9	4.2	4.1	4.0

(1) Notifications (October 2007)

(2) Outlook

(3) Privatisation alone does not have any impact on the amount of the debt. However, privatisation revenues 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 unapproved privatisation transactions. Should some of the planned privatisation projects take place and should privatisation revenues be used to finance government expenditures, the government debt would increase at a slower rate than in the outlook.

3.6 The Budgetary Impact of Major Reforms

The fiscal outlook for the period 2008 to 2010 is affected by the approved set of reform measures. The plans to carry out these measures were presented in last year's CP update. A significant part of these measures was incorporated into the legislative changes and then into the 2008 state budget and its medium-term outlook.

Some of the measures have fiscal motives, especially the need to lower the government deficit. Another part of the measures aims at meeting the priorities of the National Reform Programme, in particular, supporting economic performance and improving the labour market. Table 3.6 summarises the effects of all active budgetary measures. One aspect deals with fiscally motivated expenditure savings in the area of social benefits⁸ and wages and salaries. Another aspect involves increasing expenditures that have a positive effect on economic growth and employment.

⁸ Adjustments are not only made to the social system to achieve budgetary savings, but also to increase motivation with respect to economic activity and to reduce the distortion effect of the system on the decision-making of economic agents.

Table 3.6: Balance of the effects of budgetary measures

% of GDP	Year 2007 (1)	Year 2008 (2)	Year 2009 (2)	Year 2010 (2)
No-policy-change scenario				
Government balance - Autumn 2006 (last year's update)	-4.0	-3.5	-3.2	.
Change in no-policy-change scenario	0.6	0.3	0.5	.
Government balance - Autumn 2007 (current update)	-3.4	-3.2	-2.7	-2.4
Impacts of budgetary measures				
Revenue	-	0.2	-0.4	-0.8
Taxes	-	0.2	-0.4	-0.6
Social contributions	-	0.0	0.0	-0.1
Expenditures	-	-0.2	-0.5	-0.9
Social transfers	-	-0.8	-0.8	-0.9
Compensations of employees	-	-0.1	-0.2	-0.3
Other expenditure cuts and savings	-	0.0	-0.1	-0.4
Increase in investment to infrastructure	-	0.3	0.2	0.3
Other expenditure measures	-	0.4	0.3	0.4
Government balance	-	0.3	0.1	0.1
Fiscal targets				
Government balance	-3.4	-2.9	-2.6	-2.3

(1) Notifications (October 2007)

(2) Outlook

Source: Ministry of Finance

Reducing the deficit in the autonomous scenario between last year's CP update and the current CP update has developed out of the more favourable assumptions on macroeconomic development, which are reflected in higher estimated revenues from taxes and social contributions.

Fiscally motivated expenditure savings contribute to a reduction in the general government deficit of 0.9 of a percentage point of GDP in 2008, of 1.1 percentage points of GDP in 2009 and 1.6 percentage points of GDP in 2010. This savings is used in part to gradually lower the tax burden of labour and legal entities and in part to strengthen expenditure priorities.

Additional revenues as a result of better-than-expected macroeconomic development are fully used to lower the deficit. At the same time, the expenditure side is being restructured from mandatory expenditures to discretionary expenditures and the revenue side from direct to indirect taxation (see Section 5 for a more detailed description of the measures).