

# 5 Quality of Public Finances – Revenues and Expenditures

## 5.1 The Government's Strategy

One of the objectives of the government's strategy is to improve the quality of public finances, especially in the areas of fiscal discipline, effective management of government expenditures and tax administration, long-term sustainability and the institutional framework. In this respect, the government approved a set of measures in 2007 on the revenue and expenditure side geared to stabilising public finances and lowering the general government deficit below 3% of GDP in 2008 (see Section 3 for details). Over the longer-term horizon, the government's objective involves reforms of the pension and healthcare systems, which strengthens the long-term sustainability of public finances (see Section 6 for details). Measures relating to the quality of the institutional framework are discussed in Section 7.

With respect to restructuring the expenditure side, the austerity measures in the area of social mandatory expenditures play a key role. The said measures will slow down the growth dynamics of these expenditures and will make state assistance in the social sphere more effective.

Another important area helping to limit the mandatory and quasi-mandatory expenditures in the general government is expenditures for employee wages in state administration.

In addition to the fiscal targets, the planned measures also monitor fulfilment of the priorities contained in the National Reform Programme. This involves, in particular, promoting economic growth and employment by reducing the overall tax burden of economic agents. The shift of the tax burden from direct taxes to indirect taxes will continue. At the same time, simplifying the tax system will reduce the administrative burden and tax distortion.

## 5.2 General Government Revenues

In addition to deficit reduction, the approved expenditure oriented consolidation allows another gradual decline in the compound tax quota. The tax burden in terms of the compound tax quota was in a range of 36.0% of GDP in 2006 and recorded a year-on-year decrease of 0.8 of a percentage point. The gradual decline in the tax quota was the result of total tax revenues being lower than unit elasticity vis-à-vis GDP and also measures geared to reducing the high taxation of labour and legal entities. Direct taxation in the form of current income taxes will decline from 8.8% of GDP in 2007 to 7.5% of GDP in 2010 (see Table 5.1).

On the contrary, the increase in indirect taxation will work towards increasing the share of general government revenues in GDP. This increase is evident from the year-on-year increase in the share of taxes for production and import (particularly VAT and excise tax) from 10.9% of GDP in 2007 to 11.5% of GDP in 2008. In future years, an autonomous decline will occur due to lower-than-unit elasticity of indirect tax revenues in GDP.

The revenues from social contributions will be, among other things, adversely affected by introducing a maximum assessment base, and starting from 2009, also by adjustments to the

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sickness insurance system (see Box 5.2 for details). As a result, their share in GDP will gradually decline from 16.2% in 2006 to 15.0% of GDP in 2010.

The share of total general government revenues in GDP will decline from 40.7% in 2006 to 37.1 % in 2010.

**Table 5.1: General Government Revenues**

% of GDP	ESA code	Year 2006	Year 2007 (1)	Year 2008 (2)	Year 2009 (2)	Year 2010 (2)
<b>Components of revenues</b>						
<b>Total taxes</b>		<b>19.7</b>	<b>19.7</b>	<b>19.7</b>	<b>18.9</b>	<b>18.3</b>
Taxes on production and imports	D.2	10.9	10.9	11.5	11.1	10.8
Current taxes on income, wealth etc.	D.5	8.8	8.8	8.2	7.7	7.5
Capital taxes	D.91	0.0	0.0	0.0	0.0	0.0
<b>Social contributions</b>	<b>D.61</b>	<b>16.2</b>	<b>16.2</b>	<b>15.9</b>	<b>15.4</b>	<b>15.0</b>
<b>Property income</b>	<b>D.4</b>	<b>0.8</b>	<b>0.6</b>	<b>0.5</b>	<b>0.5</b>	<b>0.4</b>
<b>Other</b>		<b>3.9</b>	<b>3.3</b>	<b>3.3</b>	<b>3.3</b>	<b>3.4</b>
<b>Total revenue</b>	<b>TR</b>	<b>40.7</b>	<b>39.8</b>	<b>39.5</b>	<b>38.1</b>	<b>37.1</b>
<b>p.m.: Tax burden</b>		<b>36.0</b>	<b>35.9</b>	<b>35.7</b>	<b>34.3</b>	<b>33.3</b>

(1) Estimate

(2) Outlook

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

### Box 5.1: Changes in taxation

#### Personal income tax (PIT)

As of 1 January 2008, a flat PIT rate of 15% will be valid in the Czech Republic for so-called “super-gross wages” (gross wage plus premiums paid by employers, which will increase the tax base by 54.3%). The rate should be reduced to 12.5% on 1 January 2009 (however, the new amendment to the Income Tax Act planned for the first half of 2008 will set the concrete rates). The same rates will apply to most items subject to withholding taxes (for PIT and CIT). Changes will also occur with respect to tax credits. Starting on 1 January 2008, the credit for a taxpayer or spouse with no income will be increased from CZK 7,200 to CZK 24,840, and starting on 1 January 2009, this credit will be reduced to CZK 16,560 due to lowering the tax rate. Credits for children in 2008 will increase from CZK 6,000 to CZK 10,680, and reduced to CZK 10,200 in 2009. Credits for students should be CZK 4,020 for both years. Joint taxation of spouses will be cancelled, as well as the minimum tax base for self-employed individuals.

The changes relating to PIT reduce general government revenues by ca CZK 21 billion in 2008, ca CZK 30 billion in 2009 and ca CZK 34 billion in 2010.

#### Corporate income tax (CIT)

As of 1 January 2008, the CIT rate will be reduced from 24% valid for 2007 to 21%, further to 20% starting on 1 January 2009 and finally to 19% from 1 January 2010. In this way, the long-term process of reducing the CIT rate will continue. The tax rate reduction will be accompanied by some expansion of the tax base. This will involve, in particular, tightening the rules for low capitalisation and restricting the tax-deductible nature of interest, as well as additional taxation of unpaid obligations, taxation of other revenues for lotteries and gaming above the actual waged amounts, cancelling tax deductions on receivables due up to 31 December 2004 and certain other changes in the area of the creation of reserves.

The total decline in revenues as a result of the CIT measures are expected to be ca CZK 9 billion in 2008, ca CZK 24 billion in 2009 and ca CZK 34 billion in 2010.

### Value added tax (VAT)

Two rates for value added tax exist side by side in the Czech Republic – the reduced 5% rate and the 19% standard rate. As of 1 January 2008, the reduced VAT rate will be increased from 5% to 9%. The rate increase concerns especially food, construction work for social housing and housing services and regular mass transportation.

Keeping two tax rates (the standard tax rate will remain 19%) helps maintain the social sensitivity of reform with respect to the economically inactive population, such as pensioners or non-working parents with children, and low-income households. The rate increase is not expected to fully affect the final retail prices of certain products and services on highly competitive markets, such as the food market. In order to support environmentally friendly behaviour, certain products were reclassified as items with a reduced tax rate, and consideration is being given to other products as well.

This measure is expected to increase state budget revenues annually by ca CZK 27 to 29 billion during the specified years.

### Excise taxes

Starting in 2008, taxes on cigarettes and tobacco are to increase. The price of a pack of cigarettes should increase by up to CZK 7. The tax on tobacco is currently CZK 905 per kilogram, and this tax should increase to CZK 1,280 per kilogram.

Another change in excise taxes is the introduction of an environmental tax on electricity, natural gas and solid fuels.

Electricity: As of 1 January 2008, an electricity tax of CZK 28.30 per MWh will be introduced. However, some exceptions will be made (e.g. for mass rail transportation or ecological production).

Natural gas: As of 1 January 2008, a natural gas tax of CZK 30.60 per MWh will be introduced for heat production. An engine tax will be introduced and gradually increased to CZK 264.8 per MWh by 2020 (no tax exists at this time). An exception will be, for example, households using natural gas for heating. This tax will not apply to fuel for boats either.

Solid fuels: The rate will be CZK 8.5 per GJ and will not apply to electricity producers.

These measures should bring an additional CZK 11.6 billion in revenue in 2008, of which CZK 4.6 billion will be for environmental taxes.

### Property taxes

As a part of the changes to the tax system in the Czech Republic, exemptions for inheritance and gift taxes will be expanded so that they apply to relatives and persons living with a decedent or donor in one household. New powers relating to real estate tax will pass to the municipalities, such as influencing the amount of the tax or exempting farmers from paying taxes on agricultural land.

The impact of the changes in property taxes anticipate a reduction in public budget revenues of ca CZK 0.4 billion.

The active tax policy measures are summarised in Table 5.2 below.

**Table 5.2: The impact of tax changes on general government revenues**

CZK bn	Year	Year	Year
	2008	2009	2010
<b>Taxes total</b>	<b>7.9</b>	<b>-14.7</b>	<b>-27.9</b>
<b>Taxes total (% of GDP)</b>	<b>0.2</b>	<b>-0.4</b>	<b>-0.6</b>
of which: Value added tax	27.2	28.0	29.2
Personal income tax	-21.2	-30.1	-34.3
Corporate income tax	-9.3	-23.8	-34.0
Excise taxes	11.6	11.6	11.6
Property taxes	-0.4	-0.4	-0.4

Source: Ministry of Finance

### 5.3 General Government Expenditures

In view of the slow decline in the share of revenues in GDP, fiscal consolidation relies on the savings from the expenditure side of the public budgets. The overall tendency towards a decline in general government expenditures vis-à-vis GDP is, in turn, supported by the government's active austerity measures and, similar to the revenue side, the under-proportional growth of certain general government expenditures with respect to a high GDP growth rate.

Low growth in the volume of wages and salaries in state administration will be reflected in the declining share of general government expenditures for the compensation of employees in GDP. The government's objective is to increase the volume of wage resources in the state-regulated sphere by only 1.5% per year. An increase in the average wage to a level of at least 4.5% and also increasing the efficiency of state administration should be ensured by a reduction of at least 3% in the number of employees in public administration per year. Nevertheless, the outlook assumes a substantially faster increase in the volume of wages in the general government (ca 3.5% per year). Employment in the sector as a whole significantly exceeds the regulated sphere, and the remainder of the government sector apparently will not fully follow the government's objectives. The share of compensation of employees in GDP will drop from 7.8% in 2006 to 6.7% of GDP in 2010.

The share of government expenditures in the purchase of goods and services will also experience a declining trend. The austerity measures will be reflected in the share of total government consumption in GDP, which will decrease from 21.2% to 17.4% during the period 2006 to 2010.

A decisive means of consolidation for meeting the fiscal targets, however, will be the savings in the area of mandatory and quasi-mandatory expenditures, which make up almost three fourths of the total expenditures in the state budget for 2007. The government approved reform measures described in Box 5.2 are then expected to be positively reflected in the decline in the share of total social transfers in GDP from 17.9% in 2006 gradually to 16.3% of GDP in 2010. Any expenditures for social benefits other than in-kind benefits will register the largest decline. Between 2007 and 2008, these expenditures will decline from 13.0% to 12.3% of GDP, and by 2010, will continue to decline to 11.5% of GDP.

On the contrary, gross creation of fixed capital will register an increase, which will increase in terms of its share in GDP from 5.0% in 2006 to 5.6% of GDP in 2010 as a result of investment projects financed through EU funds, among others. A gradual increase in the drawdown of resources should be reflected first in a high and then gradually lower growth rate of government investment.

The share of granted subsidies and current and capital transfers in GDP (in Table 5.3, a part of the item "Other") shows only a slight decline up to 2010 in comparison with 2006.

Interest payments for the general government will slightly increase from 1.1% in 2006 to 1.2% of GDP in 2010 due to an increase in interest rates on newly issued bonds.

The share of total expenditures in GDP for 2006 declined year-on-year by 1.3 percentage points to 43.6% and should continue to decline to 39.4% of GDP by 2010.

Table 5.3: General government expenditures

% of GDP	ESA code	Year 2006	Year 2007 (1)	Year 2008 (2)	Year 2009 (2)	Year 2010 (2)
<b>Components of expenditures</b>						
<b>Compensation of employees</b>	<b>D.1</b>	<b>7.8</b>	<b>7.6</b>	<b>7.3</b>	<b>7.0</b>	<b>6.7</b>
<b>Intermediate consumption</b>	<b>P.2</b>	<b>6.6</b>	<b>5.8</b>	<b>5.5</b>	<b>5.1</b>	<b>4.8</b>
<b>Social transfers</b>		<b>17.9</b>	<b>18.2</b>	<b>17.4</b>	<b>16.8</b>	<b>16.3</b>
Social transfers in kind supplied via market producers	D.6311, D.63121, D.63131	5.3	5.2	5.1	5.0	4.8
Social transfers other than in kind	D.62	12.6	13.0	12.3	11.8	11.5
<b>Interest expenditure</b>	<b>EDP D.41</b>	<b>1.1</b>	<b>1.2</b>	<b>1.3</b>	<b>1.2</b>	<b>1.2</b>
<b>Subsidies</b>	<b>D.3</b>	<b>1.9</b>	<b>2.0</b>	<b>2.2</b>	<b>1.9</b>	<b>1.8</b>
<b>Gross fixed capital formation</b>	<b>P.51</b>	<b>5.0</b>	<b>5.1</b>	<b>5.3</b>	<b>5.4</b>	<b>5.6</b>
<b>Other</b>		<b>3.3</b>	<b>3.4</b>	<b>3.6</b>	<b>3.3</b>	<b>3.1</b>
<b>Total expenditures</b>	<b>TE</b>	<b>43.6</b>	<b>43.3</b>	<b>42.4</b>	<b>40.7</b>	<b>39.4</b>
<b>p.m.: Government consumption (nominal)</b>	<b>P.3</b>	<b>21.2</b>	<b>20.0</b>	<b>19.1</b>	<b>18.2</b>	<b>17.4</b>

(1) Estimate

(2) Outlook

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

## Box 5.2: Changes in social security

### Adjustments to social and health insurance

The effective date of the new Act on **Sickness Insurance** was postponed until 1 January 2009. On the basis of the Act on Stabilisation of Public Finances, the following measures will be taken as of 1 January 2008: the entitlement to sickness benefits, salary or service income for the armed forces for the first three days of work disability will be cancelled for sickness insurance. From the 4<sup>th</sup> to 30<sup>th</sup> calendar day of work disability, the sickness benefit is calculated as 60% of the daily assessment base, from the 31<sup>st</sup> to 60<sup>th</sup> day 66%, and from the 61<sup>st</sup> day 72% of the assessment base. The maximum monthly sickness benefit will also be reduced (according to income, up to CZK 3,500). The amount of support when treating a family member is 60% of the assessment base, and the monetary assistance for maternity leave 69% of the assessment base. Considering the fact that the expected impact of the new Act on Sickness Insurance on the revenue side of the budgets will increase over time, the savings related to postponing the act one year against last year's budgetary outlook will be ca CZK 10 billion in 2008 and also in 2009.

Incorporating parametric changes decisive for the payment of benefits into the existing act will produce savings of CZK 6.8 billion in 2008 on the expenditure side. Incorporating parametric changes into the new act effective on 1 January 2009 will generate savings of CZK 2.6 billion in 2009 and CZK 6.5 billion in 2010.

The effective date of the Act on **Casualty Insurance** has been postponed for two years to 1 January 2010. By delaying this act, the deficit for the general government will increase by CZK 2.5 billion in 2008 and by CZK 1.6 billion in 2009 against last year's budgetary outlook. On the contrary, there should be a positive impact on the balance of CZK 1 billion in 2010.

As of 1 January 2008, an annual maximum assessment base for the payment of premiums will be introduced (which has so far only been introduced for self-employed individuals) for employees and self-employed individuals amounting to 48 times the monthly wage per calendar year (i.e. four times the average annual wage in the national economy).

For health insurance, the assessment base relating to the state budget payment, in which the state is the contributor, has been revised. This rate will remain 25% of the average wage, however, without increasing it by the calculation coefficient. In this respect, **expenditure growth for the state payment to the public health insurance system has been frozen**. As a result of this measure, the estimate of savings against expenditures in the outlook are CZK 3.4 billion in 2008, CZK 6.4 billion in 2009 and CZK 2.0 billion in 2010. The government anticipates additional austerity measures in 2010 amounting to CZK 6.6 billion. Nevertheless, the relevant legislative changes have not yet been approved for this year.

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The overall impact of the measures for social and health insurance on the general government balance amount to approximately CZK 12.4 billion in 2008 (0.3% of GDP), CZK 10.6 billion in 2009 (0.3% of GDP), and CZK 8.9 billion in 2010 (0.2% of GDP).

In additions to these effects, **introducing service charges** to the healthcare system (see Box 6.1) can be expected to limit fund drawing for healthcare, which results in savings of around CZK 4 billion per year for social transfers in kind.

### Government welfare benefits

**Child benefits** will be paid as a fixed amount, increasing as the child gets older. CZK 500 per month will be paid out for the first age category up to six year old, CZK 610 for the six to 15 year category, and CZK 700 for children 15 to 26 years old. The entitlement is restricted by income to 2.4 times the minimum subsistence level of a family for all age categories.

As for **social care benefits**, the entitlement limit will be reduced from 2.2 to 2 times the minimum subsistence level of a family. The amount of the benefit will be further reduced as the income of the family increases. The lowest payment will still be CZK 50 per month.

**Parental contributions** have been proposed as a “three-speed” system. The monthly benefits may be paid out as CZK 11,400 for a period of 24 months (faster drawdown), CZK 7,600 for a period of 36 months (classical drawdown), or the four-year option where CZK 7,600 will be paid out for a period of 21 months and then CZK 3,800 for the remaining time (slower drawdown). Parents may initially choose the payment option but may not change their mind during the process. For parents caring for disabled children, the parental contribution will be kept at the base rate (i.e. CZK 7,600) for a period of seven years.

**Maternity benefits** are set as one payment of CZK 13,000 for each child born as of the effective date of the act, regardless of the number of children born or the order in which they are born.

**Foster care benefits** are set as a fixed payment of CZK 8,000, CZK 9,000, and CZK 10,000 increasing with the age of the child in three age categories (see child benefits for the age categories).

**The benefits for school supplies** will be cancelled.

**Funeral benefits** set as a fixed amount will not be adjusted and will only be paid in exceptional cases (e.g. funerals for unsupported children).

The total savings on the expenditure side relating to the above measures is estimated to be ca CZK 8.5 billion in 2008, ca CZK 10 billion in 2009 and ca CZK 13 billion in 2010.

### Other adjustments in the social sphere

**The automatic indexation of most social care benefits has been abolished insofar that the benefit amounts are no longer derived from the minimum subsistence level (set as a fixed amount in CZK). The automatic annual indexation of the amounts** for the minimum subsistence and existence levels **themselves will also be cancelled**. The government may optionally set the terms and hence influence the benefit amounts as well, especially for poverty relief assistance, which will still be derived from the minimum subsistence level. The existing indexation scheme will be maintained for pensions.

With respect to the **benefits for poverty relief assistance**, the terms for paying benefits will be more stringent for persons who have been unemployed long-term and who have not made any or very little effort to earn an income (e.g. requalification, participation in further education projects, etc.). Should these persons not work for 12 months or more, they will be paid the minimum existence level set by law (now CZK 2,020 per month) instead of the minimum subsistence level. This regulation does not apply to persons over 55 years of age, partially disabled persons and parents caring for children younger than 12 years of age.

A person who is laid off due to a gross breach of work discipline is not entitled to **unemployment benefits**. In addition, a job applicant removed from the applicant list due to illegal work activities may be again added to the list after a lapse of a period of six months.

For **social care benefits**, the changes relate, in particular, to making the payment of these benefits more effective. Duplicity will be eliminated. If the recipient of the benefits is hospitalised for an entire calendar month or is placed in a correction facility or treatment facility, these benefits will be cancelled. In addition, the supervision of benefit payments will be tightened.

**Table 5.4: The impact of changes in the social legislation**

CZK bn	Year 2008	Year 2009	Year 2010
<b>Impacts on revenue</b>			
Introduction of maximum assesment base for social contributions	-6.6	-6.9	-7.2
Postponement of the act on casualty insurance	-5.9	-5.1	1.0
Postponement of the act on sickness insurance	11.3	10.1	0.0
<b>Total impact on revenue</b>	<b>-1.1</b>	<b>-1.9</b>	<b>-6.2</b>
<b>Impacts on expenditures</b>			
Postponement of the act on casualty insurance	-3.4	-3.5	0.0
Parametric changes to sickness insurance benefits	-6.8	-2.6	-6.5
Government welfare benefits	-8.5	-9.8	-13.1
State's payment into the public health insurance system	-3.4	-6.4	-8.6
Introduction of regulatory fees in health care system	-4.0	-4.0	-4.0
Pension insurance benefits	-1.6	-1.1	0.0
Other changes in the social area	-1.6	-7.1	-6.7
<b>Total impact on expenditure</b>	<b>-29.3</b>	<b>-34.5</b>	<b>-38.9</b>
<b>Impact on balance</b>			
<b>Total impact on balance</b>	<b>28.2</b>	<b>32.6</b>	<b>32.7</b>
<b>Total impact on balance (% of GDP)</b>	<b>0.7</b>	<b>0.8</b>	<b>0.7</b>

Source: Ministry of Finance

In Table 5.5 and Chart 5.1, the increase in the share of expenditures in general public services, defence and education is explicit in the structure of general government expenditures by function (COFOG). On the contrary, the expenditures for the economic affairs of the country and social matters have registered a decline over time. The expenditures for the sector of government institutions, expressed by the share in GDP, have shown a relatively stable value of around 44% during the past two monitored years with a slight declining tendency.

**Table 5.5: General government expenditures by function**

% of GDP	ESA code	Year 2001	Year 2002	Year 2003	Year 2004	Year 2005
1. General public services	1	4.2	5.0	5.2	5.0	5.5
2. Defence	2	1.6	1.6	1.9	1.4	1.8
3. Public order and safety	3	2.2	2.1	2.2	2.2	2.2
4. Economic affairs	4	9.4	8.6	8.4	7.5	6.9
5. Environmental protection	5	1.0	1.0	1.2	1.1	1.2
6. Housing and community amenities	6	1.2	0.7	1.3	0.9	1.4
7. Health	7	6.0	6.3	6.4	6.2	6.1
8. Recreation, culture and religion	8	1.1	1.3	1.3	1.2	1.2
9. Education	9	4.4	5.2	5.2	4.8	4.8
10. Social protection	10	13.3	14.5	14.3	13.6	12.8
<b>Total expenditure</b>	<b>TE</b>	<b>44.5</b>	<b>46.3</b>	<b>47.3</b>	<b>43.9</b>	<b>43.8</b>

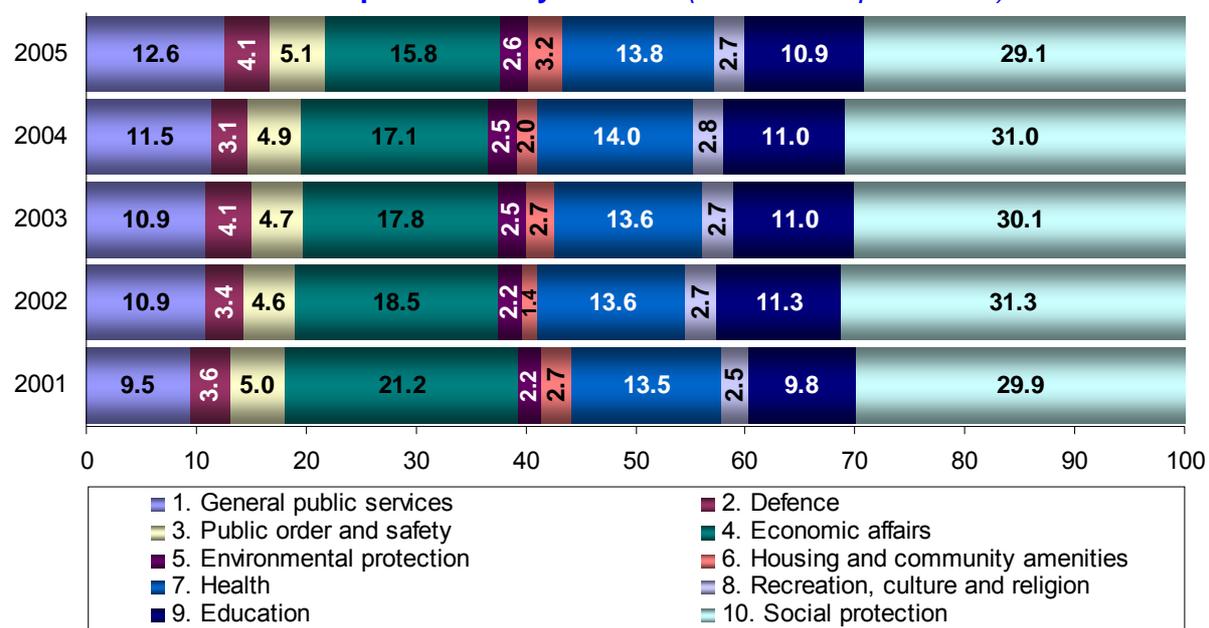
Note: Total expenditures do not correspond exactly to the current version of the annual national accounts. This is due to the different periodicity of publishing the main aggregates of the annual national accounts (every half year in April and October) and the expenditures of general government institutions by function (once a year in December).

Source: Czech Statistical Office

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In the following chart, the data for expenditures relating to special purposes are expressed by the share in total expenditures for the sector of general government institutions.

**Chart 5.1: Government expenditures by function** (% of total expenditures)



Source: Czech Statistical Office