IV. Robust economic growth did not improve the Czech public finance

The Czech Republic fulfilled the Maastricht criterion of fiscal stability for 2006 even though the debt of the general government sector was at the half of the required limit – as it did for a couple of years – and the public budget deficit ended up surprisingly closely below the required limit. This can be qualified as a positive result from the aspect of proportions of previous deficits although with respect to the strong growth of the Czech economy it cannot be regarded as a success. More than that, nothing has changed the fact that the risk of internal imbalance is high and the sustainability of the Czech finance is disputable if no reforms take place. The Czech economy would have to reach a 5% rate of growth p.a. in the next three years to reduce the budget deficit without reforms below a hundred billion limit provided that no proposals increasing further the state mandatory expenditures are adopted and at a price of setting aside the agreement with the European Commission on the strategy of reducing relative budget deficits.

The most serious risk threatening internal balance of the Czech economy related to public finance[4] is the risk of delay .

The need of the general government sector of the CR to be funded from other entities – this is one of the applicable definitions of the government deficit – amounted in 2006 to CZK 94.485 billion which is 2.9% of nominal GDP[5]. The figure from the report quantifying the net borrowings of the general government sector calculated by the CZSO using methodology of national accounts in compliance with ESA95 was confirmed by the European Commission, and so was the amount of adjusted budget deficits for the period 2003-2005 years (chart 1).

In the period 1995-2006 the deficit was reduced below 3% of GDP as required by convergence criterion for the first time in 2004 (2.9% HDP); in 2005 the adjusted balance was 3.5% of GDP. The programme of convergence for 2005 counted on the deficit of 4.8% of GDP and the more favourable result than expected in the programme was due to more effective tax collection.

The deepest deficits of public budgets were recorded in the Czech economy in 2002 (-6.8% of GDP) and in 2003 (-6.6% of GDP).

In 2006 the deficit was increased primarily by state finance…

In 2006, the deficit of the Czech general government sector was adversely affected mainly by the state finance management, i.e. according to ESA95 methodology by the central government deficit – the deficit in relation to GDP (3.1%) was even deeper than total deficit of the general government sector (2.9%). This phenomenon was, in compliance with available data, recorded only in 2005 and also at the beginning of the latter half of the 90´s when the passive balance of the state budget in relation to GDP was significantly worse than the already relatively deep deficit of the whole general government sector. In 2001-2005 the state finance deficit dominated the public budget deficit, nevertheless the “rest“ of the general government sector reached more favourable ratio and resulted into the improved negative balance of the whole general government sector measured as GDP percentage compared to similar ratio calculated only for the state finance.

The state budget deficit as a decisive cause of public finance deficit deteriorated in 2006 compared to 2005 due to lower than expected amount of collected direct taxes and higher dynamics of expenditures. These exceeded revenues by CZK 97.3 billion and thus the balance against the budget was by CZK 13.6 billion higher; compared to the result of 2005 even by CZK 40.9 billion. Its ratio to nominal GDP reached 3.1% (in 2005 it was 1.9%).

Rate of growth of state expenditures exceeded the dynamics of its revenues

Tax revenues[6] as key revenues of the state budget were in total higher compared to 2005 by 4.1% and reached CZK 802 billion; this growth was attributed mainly to social security insurance payment (+7.2%) in the amount of CZK 333.8 billion. Tax revenues (excl. insurance payment) increased only by 1.9% to CZK 468.2 billion. This result was reached when the collection of direct taxes dropped, the income from taxes of legal entities was, compared to 2005, lower by 4.8% and collection of taxes on income of physical persons dropped by 3.3%. Taxes on income of legal entities (CZK 95.5 billion) thus did not exceed the hundred billion limit as in 2005, taxes on income of natural persons (CZK 91.7 billion) were lower, y-o-y, by CZK 3.1 billion. Ambitious budgetary expectations were not met – the result reached in 2006 compared to the budgeted level was lower both in case of tax revenues as such and social insurance payment. A moderately decelerating rate of growth of GDP was recorded (y-o-y by 7.4% in Q1 compared to 5.8% in Q4).

[4] The concept of public finance or public budgets covers, in compliance with national accounts methodology, budgets of all institutions classified to the general government sector.

[5] Source of data on government deficit and debt for the CR or other countries in this analysis is mainly data approved by Eurostat from the deficit and debt notification prepared by the CZSO in compliance with ESA95. methodology. The Ministry of Finance of the CR reports on the deficit and debt in compliance with the IMF Government Financial Statistics methodology. It records book operations also on accrual basis (transactions and other economic flows are recorded at the moment when the economic value is formed, transformed and ceases to exist and also when claims and liabilities increase, cease to exist or are transformed). It includes all factors affecting financial performance, situation or liquidity of the general government sector. In its substance it is close to ESA95 methodology.

[6] Source: Ministry of Finance of the CR, report on performance of the state budget for 2006 prepared in January 2007.

Budget expenditures exceeded the amount of a billion crowns and showed, compared to revenues, faster dynamics – they increased compared to 2005 by 10.6% to CZK 1020.6 billion. Although, the 2006 budget counted on their growth by more than CZK 50 billion, the actual increase almost doubled and reached CZK 97.8 billion. Current expenditures exceeding nine tenths of total expenditures increased, y-o-y, by 8.5% to CZK 912.1 billion, capital expenditures with a substantially lower weight in the budget rose by a third to CZK 108.5 billion.

Mandatory expenditures of the state budget take an upward trend again…

In 2006, mandatory expenditures[7] measured in relation to economic performance of the country and in relation to the amounts on revenue and expenditure sides of the state budget increased again. Mandatory expenditures have to be paid by the state in compliance with legislation in force or with other contractual obligations. This applies to pensions, sickness benefits and state social support, state contributions to health insurance, expenditures on debt service, contributions to building-in-society saving, contributions to political parties, contributions to supplementary pension insurance, support of exports, mortgages or transfers to international organizations. Shares of these expenditures in budget revenues and expenditures were gradually reduced in the period 2003-2005 – if in 2003 they made 61% of the budget revenues and 53% of budget expenditures, in 2005 the respective percentage were 54% and 51%. The year 2006 recorded a repeated growth of the shares to 57% (revenues) and 53% (expenditures).

Jump growth of mandatory expenditures in connection with new social benefits (e.g. birth grant and parent allowance) in the approved budget for 2007 catapulted the shares of mandatory expenditures to three fifths of the budget, i.e. higher share compared to 2003.

…just like quasi-mandatory expenditures

Besides mandatory expenditures as required by law or respective contracts dominated by social transfers the state spends money on quasi-mandatory expenditures which are not anchored in law but the state may not waive them. These include mainly wages of employees of the budgetary and semi-budgetary sphere, expenditures on defence or investment incentives – pro-growth character has only a small part of quasi-mandatory expenditures. In 2006, their share in the state budget expenditures made more than a fifth (22%) and by almost same percentage they participated in budget revenues (23.9%). Their contribution to nominal GDP was 6.6%.

For the last years development it is typical that the state has an incomplete fifth of the state budget revenues left for funding of economic growth since altogether the share of mandatory and quasi-mandatory expenditures in the state budget of the CR makes about 80% of the budget revenues.

Positive correction through robust economic growth

Mandatory budget expenditures in ratio to GDP would have reached even higher percentage if not corrected by strong growth of the Czech economy since 2003. In 1995, the shares of mandatory expenditures to budget revenues and expenditures were 44% and 44.8%, respectively. In 2007, these shares are expected to increase, in compliance with the CNB estimates, to 66% and 60%, respectively. It can be stated that social state in CR was strengthened.

Mandatory expenditures are a great burden for government expenditures. Key items of mandatory expenditures, i.e. social transfers of which mainly pension insurance benefits will demand, in the future, thanks to demographic development, increasing amounts allocated to state expenditures also in case the intended parametric changes of the pension scheme are implemented.

New acceleration of legal mandatory expenditures is expected in 2007

The efforts to win voters´ favour before elections to the parliament in the spring 2006 had a significant impact on the size of legal mandatory expenditures in the 2007 state budget (their growth was during the discussion on budget approved without respective legislation being adopted). In addition to the fact that mandatory expenditures will obviously hit the limit of two thirds of the state budget revenues, the year 2007 may bring an adverse aspect in connection with the convergence criterion – the CR probably will not be able to meet the goal of the procedure applied in case of excessive deficit (the procedure was started up with the CR upon accession to the EU in 2004 and includes the goals of the government regarding the cut back on the deficit below 3% of GDP). The CR thus will not be able to reduce the public finance deficit agreed upon with the European Commission. The estimated result for 2007 in the amount of 4% of GDP exceeds the agreed goal for this year (-3.3% of GDP). Due to this the CR will breach the simulated process of cutting public finance deficit.

Government debt stabilization?

Gross consolidated debt of the general government sector of the CR in relative terms seems to be stabilized in the time series from 2003 standing at 30% of nominal GDP. This relatively favourable ratio can be sustained - given fast nominal growth of debt – thanks to robust growth of the Czech economy. At a downward stage of the economic cycle a problem related to the proportional amount of the debt may appear.

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[7] The state budget mandatory expenditures include items which the state shall appropriate in compliance with law and those resulting from other legal regulations or contractual obligations. In addition, there exists an indirect state obligation to provide money from the budget on quasi-mandatory expenditures.

Gross consolidated government debt of the CR reached in 2006 the total of CZK 973 billion, i.e. 30.4% of GDP. This ratio means the amount of debt markedly below the limit given by Maastricht criterion for adoption of the Euro (60% of GDP). Considering this aspect the CR in 2006 ranked among the EU countries with the lowest debt.

However, the general government debt grows very fast (in 2003, the debt amounted to CZK 775.0 billion). On average, in the period 1998-2006 the general government debt grew annually by 17.6%, state debt by 18%. The ever fastest grow of debt recorded for general government sector in the period 2000-2002 due to necessity to solve the burden of transformation costs – the government debt increased in 2000 and 2002 by almost a fifth (+19,1% and +18,7%) and in 2001 even by 45.9%. In that period the stabilisation of loan portfolios of the biggest banks culminated as well as of some significant non-financial enterprises (České dráhy).

Since 2002, the rate of debt growth declines, expectations for 2007 count again on a moderate y-o-y increase. The latest prediction on macroeconomics prepared by the Ministry of Finance in April 2007 estimates that the gross consolidated government debt will increase in 2007 to CZK 1074.2 billion, i.e. 31% of estimated nominal GDP. The growth by one tenth is expected due to faster increase of the state debt.

State budget deficit is not the only risk of growing debt

Although the state budget deficits are the decisive negative factor increasing the government debt also other debt components bear a few potential risks. Health insurance companies optically make the least burden on the general government debt (their liabilities towards medical establishments are not parts thereof), however, the health insurance scheme is not balanced and is unable to sustain long-term balance using only their own resources. Extra-budgetary funds are exposed to the risk that their own resources used to fund their deficits will shrink. Debts of municipalities (CZK 86.7 billion in 2006) are expected to grow moderately.

The Czech government debt in relation to GDP is not, compared to some European countries, high, as already mentioned. Its dynamics was markedly slowed down by high collection of privatisation revenues. The revenues will, however, shrink in the future due to the fact that the sale of state shares was mostly exhausted. In addition, the approved sale of 7% share in power production company ČEZ means in fact only an urgent solution when there is a lack of funds to cover current state budget expenditures (revenue over CZK 37 billion is expected from the sale of the above share in one of the most capitalized companies in the Central Europe, at a current price listed at the Prague stock-exchange which is enough to cover the amount of CZK 31 billion of the 2007 budget which is missing).

The only way how to reduce debt in the future is to focus on the sphere of deficits generating this debt. With the absence of income from privatisation the deficit development will directly affect the debt.

Government debt is maintained on acceptable level thanks to economic boom

Besides benefits coming from privatisation revenues from the sale of state shares in big companies – in 2005 these sales themselves reduced the government debt measured in relation to GDP by 3.5 p.p. – also strong economic growth contributes to the stabilization of the government debt contribution to GDP. According to calculations of the MF CR the increase of nominal GDP between 6-7.5% annually will contribute to the government debt reduction in relation to GDP by about 2-2.5%. The growth of the Czech economy then partly eliminates the growth of the government debt contribution to GDP ensuing from the increasing of public budgets deficits.
The above effect may lose its power when the economic growth slows down.

The Czech economy in 2006 operated above its potential

The y-o-y rates of growth of real GDP in the 2006 quarters (from 7.4% in Q1 down to 5.6% in Q4) indicate the slow-down of economic growth.

Institutions producing estimates of the Czech economy potential product growth – from 2000 a marked acceleration of its growth is recorded – in the latter half of 2006 the rate of growth was about 5% - do not consider as sustainable the situation when the economy could operate in the mid-term horizon as high above the potential product level as it did in the first half of 2006. Then, upon closing of production gap which took place in 2005, the performance of economy was about 1% above its potential.

The strongest impact on fast growing potential product had aggregate productivity of production factors. It should continue to increase its contribution to the dynamics of potential growth (continuing effects resulting form joining the EU are expected as well as growing employment) but some risks may, in contrast, reduce the growth potential of the Czech economy. Besides the public finance development also market risks (e.g. price movements of some commodities) should be mentioned.

The biggest risks threatening internal balance of the Czech economy in the fiscal sphere

The biggest risk to the internal balance of the Czech economy linked with public finance is the risk of delay. Expansive character of expenditures on pensions is boosted by ageing population – pension insurance benefits increased from CZK 186.9 billion in 2000 to CZK 263.5 billion in 2006 and the budget for 2007 plans CZK 288.3. From fiscal aspect ageing affects also the health sector and other social expenditures. Insufficient response to these developments would require in the future higher taxes and massive cuts on expenditures.

The risk of increasingly expensive debt service (interest) is also quite real. Volume of interest rates in respect of new bond issue continues to grow (debt service expenditures in 2000 amounted to CZK 17.4 billion, in 2006 to CZK 33.9 billion and for 2007 the amount of CZK 40.4 billion is allocated from the state budget). There is no problem with debt allocation since the demand thanks to good rating of the CR mostly exceeds the supply (in the period 2000-2004 with high need to fund transformation debts the volume exceeding 100-150% the volume of offered issues was demanded). Risk of negative development in the bond market is not that serious.

Possible shrinking of the public budget deficit through the reform measures would naturally mean lower need for funding. If the 2008 deficit was lower by CZK 35-45 billion, the models from financial markets suggest that revenues indicating spread with 10-year government bonds of the CR compared to the same in the EU would be lower by 20-30 base points compared to the situation when the public budget deficit would not be reduced.

Conclusion

The cure for the Czech public finance will be long-term conceptual reforms based on consent of the whole spectrum of political parties since single cuts in the state budget expenditures will not secure the future fiscal balance. The Czech economy has a built-in tendency to deepen fiscal deficit given primarily by the state budget expenditure structure and demographic development in the CR. Due to political disagreements no consolidation took place during the whole ten year period. The 2007 state budget draft approved in 2006 counted on amendments of laws on budget revenues and expenditures which have not been accepted and initiatives of deputies taken into consideration were in contrast with binding limits adopted by the CR in the Convergence Programme and with internal budget expenditure limits.

The Czech public finance undoubtedly give birth to internal imbalance trends. Neither strong economic growth recorded for the last two years was able to markedly reduce internal imbalance (while in the EU25 and in the EU15 the imbalance was reduced in the years 2005 and 2006 under a significantly lower growth of GDP compared to the CR). Assuming that the budget expenditure boom in 2007 is replaced by fiscal restriction the reduced expenditures might reflect in lower demand. As a result, lower pressure would be placed on price increase and thus on interest rate increase. The intended fiscal restriction might not then necessarily result in monetary restriction.

An independent monetary policy is and will obviously be in the upcoming years for the benefit of the country approaching the EU economic level. It is necessary to reach sustainable public finance by fiscal and monetary mix. The reason is not just quick adoption of the Euro.