Crisis Resistance and Macroeconomic Stabilization Capacity of Czech Public Finance

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1. Fiscal Space of Czech Public Finance

The first observation one can make when looking at Czech public finance is that persistent government deficits are characteristic of it and that they have predominantly structural character. The cyclical position of the economy and the cyclical parts of revenues and expenditures have played only a minor role in explaining the level and volatility of the deficit-to-GDP ratio of the Czech Republic so far.

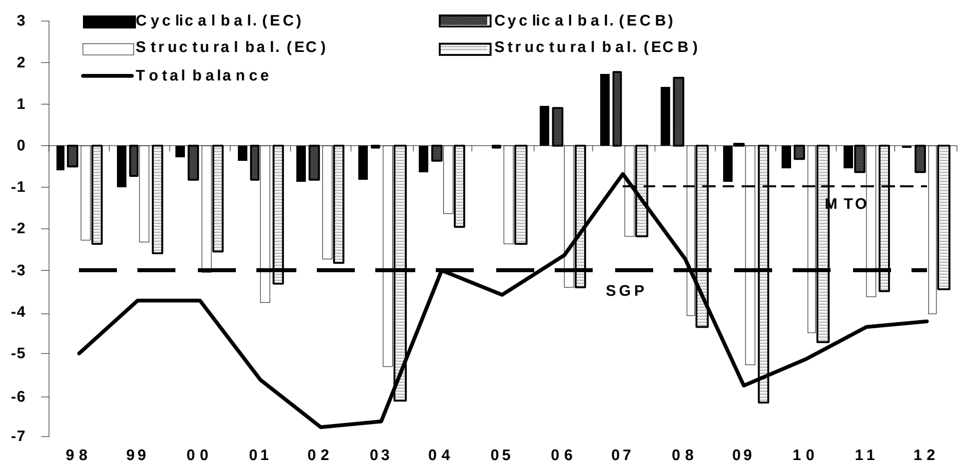
The second distinctive feature is that the Czech fiscal policy has been in most of the time pro-cyclical, which has been especially the case in the years of economic boom, when extra revenues were typically spent.

To offer this structured view, chart 1 shows developments of Czech public finance disentangling the headline government deficit into two parts – cyclical and structural (cyclically adjusted net of one-off and temporary measures) balance – using two alternative methods (the European Commission approach and the European System of Central Banks approach). One can see in the chart that – prior to the crisis – structural deficits were notoriously high as a result of a loose fiscal policy conducted in those years of prosperity (2003–2007). This disadvantageous starting fiscal situation was subsequently aggravated after the economic crisis hit the Czech Republic, when the cyclical position of the economy sharply turned

[1] I would like to thank my colleagues from the CNB, especially Dana Hájková (Head of our Fiscal Analyses Unit), for providing me with a kind assistance in preparation of my contribution to the workshop. However, any errors and omissions remain entirely my own. The views expressed herein are the views of the author and do not necessarily represent the views of the affiliated institution.

negative and automatic stabilizers started to play a role.[2] On top of that, the government approved an anti-crisis package of fiscal measures aimed at cushioning negative impacts of the crisis on Czech households and entrepreneurs. These measures led to further deteriorating of the public finance deficit.

Chart 1: General Government Balance (% of GDP)



Source: CNB.

As a result, the deficit-to-GDP ratio increased by approximately 5 percentage points between 2007 and 2009. The Excessive Deficit Procedure (EDP) was opened with the Czech Republic in late 2009 (for the second time during its EU membership) with the deadline for correction of the deficit below 3% of GDP being set by 2013.[3] This situation called for an instant and radical action of the Czech authorities that would bring deficits back under control. Such an action came relatively soon; in late 2009 the government approved its "austerity fiscal package" (see chapter 4).

[2] It is worth mentioning that the economic crisis got to the Czech Republic solely via the foreign demand channel, very negatively affecting export and production performance of the Czech manufacturing sector. Having said that, the financial impacts of the crisis on the Czech economy were very negligible thanks to a very good shape of the Czech banking sector with virtually no exposure to foreign toxic assets.

[3] For the first time, the EDP with the Czech Republic was open just after the country became a member of the EU in 2004, and the EDP was then abrogated in 2008. It is also worth noting that the Czech Republic has as yet never reached its Medium Term Objective (MTO) being set at 1 % of GDP for the structural deficit of public budgets.

2. Cyclically Adjusted Balance

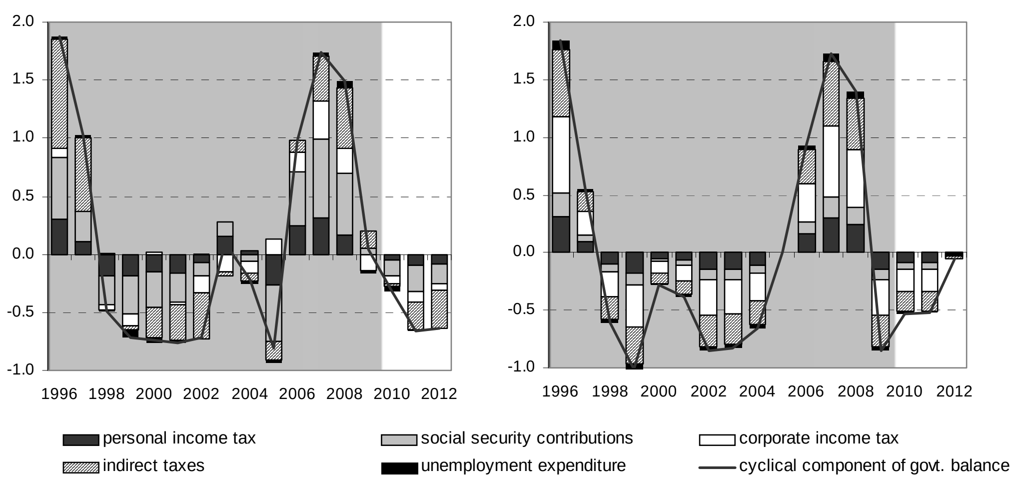
Chart 2 depicts developments of the cyclical parts of budget balance expressed by means of the two above-mentioned analytical methods (EC, ESCB). In the ESCB approach, the cycles are derived separately for each revenue item, which usually has a direct link to a relevant macro-economic assessment (tax base) variable and its cycle, respectively. That is why individual cyclical parts of revenues may go in both positive and negative direction within one time period (year). On the contrary, in the case of the EC method all the bars go always in the same direction (positive or negative). This is because, in this method, the output gap derived from a production function is a single measure of the position of the economy within the business cycle, and hence the only driver of the cyclical part of the revenues.

Chart 2: Components of Cyclical Balance (% of GDP)

Disaggregated approach (ESCB method)

Aggregated approach

(EC method)



Source: CNB.

Despite different methodologies, both approaches offer roughly the same picture indicating that corporate income tax (CIT) and social security contributions are the most cyclically sensitive items among tax revenues. During the crisis, a kind of "sudden and surprising" shortfall of budgeted revenues occurred especially in 2009 but also in 2010 concentrating in CIT revenues as shown in table 1.

Table 1: Fulfillment of Budgeted Revenues (%)

	tax revenues	VAT	CIT	PIT
2008	99	93	108	105
2009	82	91	64	80
2010	95	100	86	99

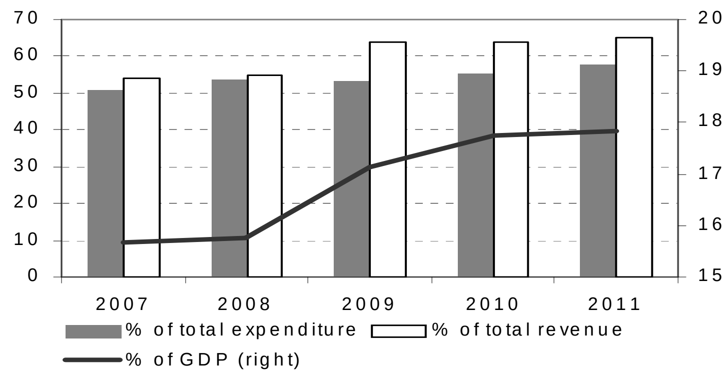
Note: Cash data, central-government budget.

Source: Ministry of Finance, press releases.

3. Mandatory Expenditures

The Czech public finance can be characterized by a high share of mandatory expenditures[4] in GDP, total expenditures and total revenues (chart 3).

Chart 3: Mandatory Expenditures



Source: CNB.

The high share of mandatory expenditures determines (and limits) the fiscal space of the government, but not in a trivial way. There is a trade-off in this respect. On

[4] A definition of the mandatory expenditures in not internationally fully harmonised as a statistical concept (variable), as far as I am concerned. In our case, the mandatory expenditures, as an analytical concept (approximation), include in particular: pension, social and health insurance benefits, government payments for health insurance, debt service expenditure, state support of building savings schemes and private pension schemes, payments to the EU budget, etc.

one hand, high mandatory expenditures may limit the fiscal room for maneuver, especially in the short run. On the other hand, mandatory expenditures represent a source of stability for the economy over the business cycle and thus work counter-cyclically. A problem arises for public finances, however, if:
(i) cyclical elasticities of revenues and mandatory expenditures are substantially different, all the more in particular if the share of mandatory expenditures is high and/or tax revenues are very sensitive to changes in GDP;
(ii) a cyclically or structurally driven increase in mandatory expenditures is not compensated by adequate cuts in other expenditures or by an increase in revenues.
Unfortunately, the Czech Republic fulfils both (i) and (ii), and therefore we consider the high share of mandatory expenditures meaning a problem for our country.

4. Fiscal Consolidation in 2010 and 2011

The above-mentioned development in 2009 led to the implementation of "austerity package", the budgetary measures of which came into effect in 2010. The new coalition government stemming from the general election held in June 2010 then continued in fiscal adjustment and prepared its "fiscal consolidation package" in relation to state budget preparation for 2011.

Table 2: Packages of Budgetary Measures Taken in the Recent Past

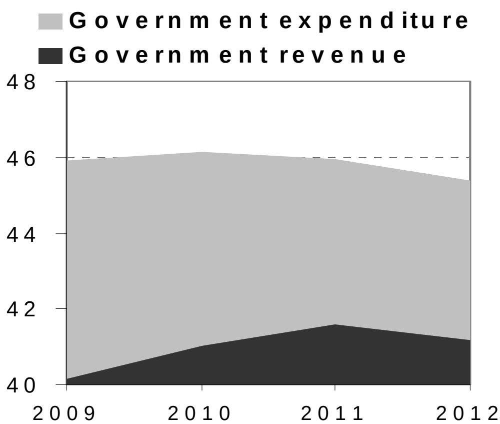
discretionary packages	impact on deficit (% GDP)			impact on GDP growth (p.p.)		
	2009	2010	2011	2009	2010	2011
of 2008	1.1	1.2		0.3	0.5	
of 2009		-2.4	-2.1		-0.8	
of 2010 (2011 state budget)			-2.2			-0.8

Source: CNB.

Both consolidation packages have had, and will have, a sizable effect on both the fiscal stance and the economic activity in the Czech Republic (see table 2 and chart 4). In total, fiscal consolidation will lead to a noticeable reduction of the general government deficit in 2010 and 2011, bringing it from 5.8 % of GDP in 2009 to 4.3 % of GDP in 2011 according to the latest available CNB's Inflation Report I/2011.

Chart 4: Forecast for General Government Expenditure and Revenue

% of GDP



Source: Ministry of Finance of the Czech Republic (2010).

Approximately two thirds of the measures in the second fiscal consolidation package were aimed at curbing growth on the expenditure side of public budgets, and included cuts in mandatory and "quasi-mandatory" outlays. The remaining one third of measures addressed tax revenues. This fiscal restriction curbed economic recovery in both 2010 and 2011 via strong deceleration of government and household consumption. Its total effect on GDP growth is estimated by the CNB to be approximately –0.8 percentage points in 2011. The government has also announced (without much details) its intention to prepare and approve some further consolidation measures to comply with the EDP deadline to correct the excessive deficit by 2013, and to reach balanced public budgets by 2016. The government plans include a launch of pension reform (see chapter 5).

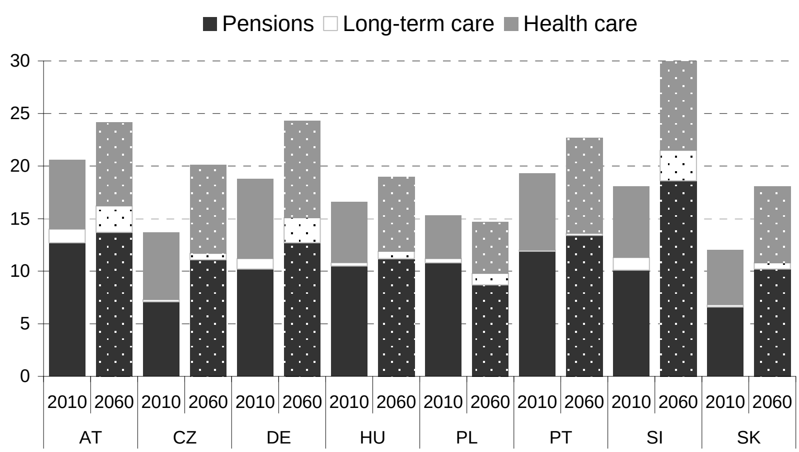
5. Sustainability of Czech Public Finance in the Long Term

5.1 Long-term Sustainability Issues

Although the medium-term oriented fiscal consolidation in the Czech Republic has successfully started in the recent past; there is still an urgent need to tackle long-term public finance sustainability issues. These arise mainly from demographic trends that lead to population ageing. Due to this factor, the Czech Republic will in the coming 50 years experience an important increase in the long-term age-related government expenditures (costs of ageing) and will reach one of the highest levels of those costs in 2060 when compared to other EU Member States (see chart 5).

Chart 5: Long-term Costs of Ageing

% of GDP



Source: European Commission (2010).

The government has recently outlined some basic elements of the pension reform, but the political discussions continue on this issue. The discussed proposal should ideally solve the two basic problems of the Czech old-age pension system, which has so far been predominantly operated within a state-owned pay-as-you-go (PAYG) framework. Those problems are its long-term unsustainability due to ageing, and its extremely high intra-generational redistribution of pensions.[5] As the ruling coalition plans it, a second fully-funded defined-benefit pillar should be introduced as from 2013. The capital of this new pillar should stem from re-directing a certain percentage (currently envisaged 3 percentage points) of social security contributions from the PAYG system to that new second pillar, with additional 2 percentage points compulsorily contributed by the individual saver (future beneficiary of an old-age pension). To finance a resulting shortfall of funds

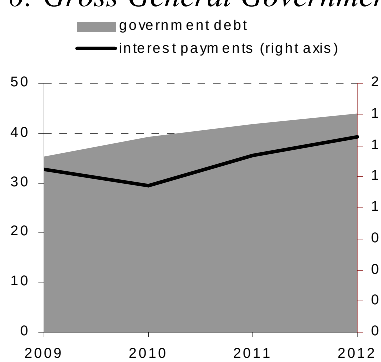
[5] Weak relation between contributions paid to the current PAYG and the level of pensions obtained from that negatively affecting especially high income brackets (low replacement rate) was a subject of a Constitutional Court resolution taken in late 2010. The government was given a deadline to correct this negative feature of the current system by the autumn of this year. A so-called “small pension reform” being currently in the pipeline should address this relatively minor issue by a couple of measures. For instance, the maximum assessment-base (ceiling) for social security contribution is to be decreased after being temporarily increased as part of the 2009 and 2010 consolidation packages.

to the PAYG, the government plans to increase the lowered VAT rate from 10% to 14% in 2012 and to unify the lowered and the basic rate at 17.5 % as from 2013.
At the time being, it is difficult to take a final position to the outlined pension reform since a lot of details have not yet been disclosed. Needless to say that health care and long-term care reform is urgently needed to cope with growing age-related costs to come in the next decades.

5.2 Short-term Sustainability Implications

If not addressed properly, the public finance sustainability issues have the potential to worsen dramatically the deficit and debt situation of the country. In the Czech Republic, the actual public-debt-to-GDP-ratio is still at quite favorable levels compared to other countries (and far below the 60% benchmark). Its recent trend, however, has been steadily and quite steeply increasing, due mainly to sizeable government deficits in the past. The fiscal consolidation undertaken so far has only lowered the pace of further increases in the indebtedness of the public sector. As a result, interest payments (debt service) have been growing over time and could potentially become a sizeable and unpleasant burden for the Czech public finance in the future. The temporary decline in the debt service in 2010 was caused by extraordinarily favorable financing conditions of that time, which will probably not repeat in the years to come. On the contrary, one can expect that, in line with the continuous increases of public debt and rising interest rates, the debt service will probably get back on an increasing path too (see chart 6). The public debt crisis in some euro area countries is in this respect a deterrent example of how unsolved fiscal issues can undermine the country's reliability and ability to finance its basic needs.

Chart 6: Gross General Government Debt and Debt Service (% of GDP)



Source: CNB.

6. Concluding Remarks

The lessons from the economic crisis emphasize the need for sound and enforceable fiscal rules, which are complied with. In this respect, the EU-level budgetary surveillance framework (Stability and Growth Pact, SGP) may be essential for some countries in particular. That is why I welcome, the European Commission's proposal on strengthening the SGP procedures and I broadly agree with the main features as proposed so far (I would be inclined to introduce even more automaticity, including earlier and more severe punishments). Simultaneously, I am convinced that the envisaged tightening of budgetary surveillance will reinforce the political efforts at national levels (political commitment and ownership concerning needed reforms and consolidation). It is true, however, that country specificities are definitely best known (and therefore possibly treated) at the national level.

For the future, it is necessary for both the Czech Republic and other EU Member States to take advantage of the times of solid economic growth, which provide a convenient environment, for responsible fiscal governance[6] and structural adjustments (unlike to what we used to see in the past in many cases). More stringent fiscal frameworks at both the national and the EU level could help in this respect. After having done medium-term fiscal consolidation, it is of the utmost importance to proceed with reasonable and timely treatment of long-term fiscal issues.

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[6] To move in this way, the Czech Ministry of Finance has recently outlined some basic features of the tax reform that should come into effect as from 2013. The goal is to simplify the tax system in order to lower the administrative costs of both, the tax payers and the state. The main elements of this reform include a unification of tax bases, a reduction in the number of tax exceptions, a compensation for the income tax on dividends, and a simplification of administrative procedures.

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