Public finance consolidation in the Czech Republic

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1. Introduction

The Czech Republic has been established 1993. Institutional environment and peoples' way on looking at life were intensively distorted by the large heritage of communism. Unsurprisingly, this was also problem for the public sector because the Czech public finance got a massive shock on both revenue side and expenditure side, chiefly the latter, of course.

After the transition period and establishing of new public institutions, new regulators and dream careers new some new bureaucrats, a development of the Czech public finance has got the standard direction: every year, a gap between expenditures and revenues generated a new deficit. And cumulating of red numbers means nothing but public debt.

A rapid increase of debt per head and debt related to GDP caused a demand for a consolidation of the public finance. However, this has not come yet. Weak governments have not found enough courage to explain to voters that turning the wheel and the rapid cut to the public sector is really necessary, although academicians and economists presented several proposals how to do it. No response.

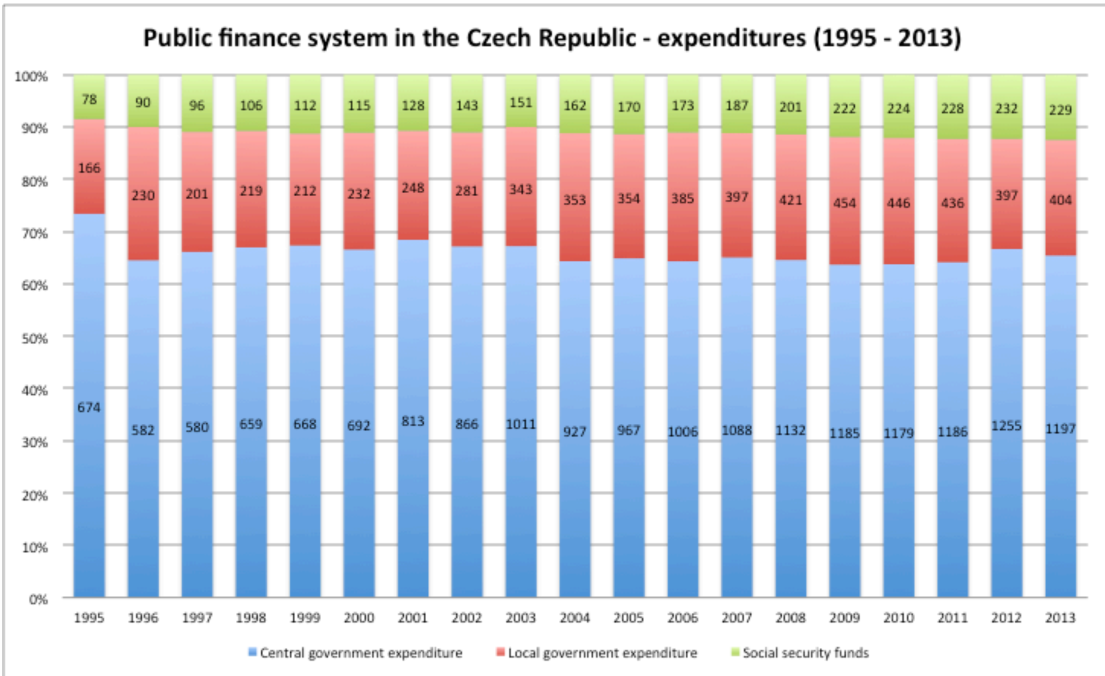
This paper deals with the issue of public finance in the Czech republic – how it operates, what is the development of key measures and indicators – and the paper also presents a proposal how to consolidate public finance. Recommendations for decision-makers conclude the paper.

2. Public finance system in the Czech Republic

The public finance system in the Czech Republic is significantly centralized. The system consists of state budget (central government institutions) and budgets of local governments and municipalities, social security funds and extra budgetary funds. All transactions together are reported as the general government budget. The majority of public resources are redistributed through central government institutions. As usual in other countries, the budgetary legislation is prepared in advance for the next year, spilling over into future years (binding). The state budget, effective under the applicable law passed by the Parliament, consists of chapters; these chapters follow the economy of individual institutions (e.g. office of the President, Parliament, ministries, bureaus, etc.). Local governments and city councils are responsible for own municipal budgets.

The graph number one shows the system from the perspective of expenditures; the volume of central government expenditures fluctuates between 60 % and 70 %.

Graph 1: Public finance system in the Czech republic



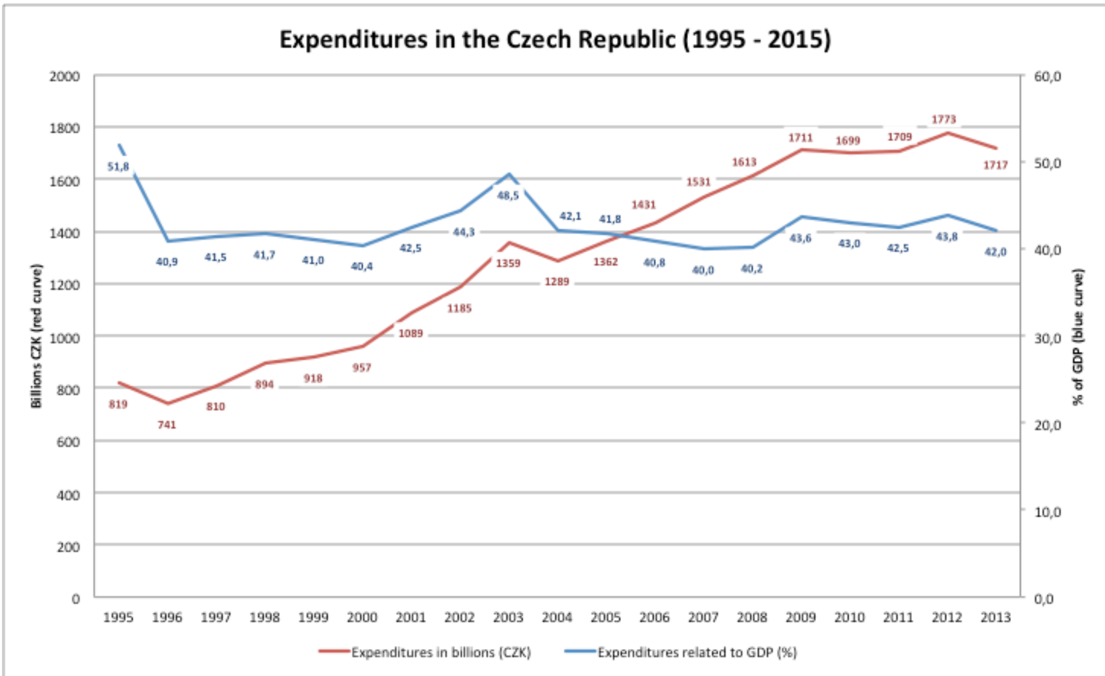
Note: The Y-axis shows a percentage on total expenditures. Numbers in columns show expenditures in billions CZK. Data source: Ministry of Finance, Czech Republic.

3. Expenditures, revenues, deficits and debt

Let's have a look on a development of the Czech public finance and its actual shape, as well as on international comparisons. For better interpretation, relative numbers (GDP ratios) are used.

Looking at expenditures, the general government expenditures averagely rose by 4 % (annual change) between 1995 and 2013, while the absolute volume increased more than twice to the level 1,700 billion CZK (over 62 billion EUR). According to the GDP ratio, we can safely say that the level of expenditures settled down between 40 and 45 % of GDP after the post-revolutionary shock (in the graph, the shock is visible from 1995).

Graph 2: General government expenditures (1995 – 2015)



Data source: Ministry of Finance, Czech Republic.

According to the international comparison, the level of public expenditures in the Czech Republic is rather low – values are below the average of both European Union and Euro Area countries. The Czech Republic – with the average value at 42 % of GDP – reports the second best result behind Slovakia among V4 countries. Moreover, aggregated outlays for the compensation of general government employees are the lowest ones among compared countries. However, the ratio of mandatory expenditures on total general government expenditures is stable and very high, which lowers a possibility of the Czech public finance to react on macroeconomic shocks.

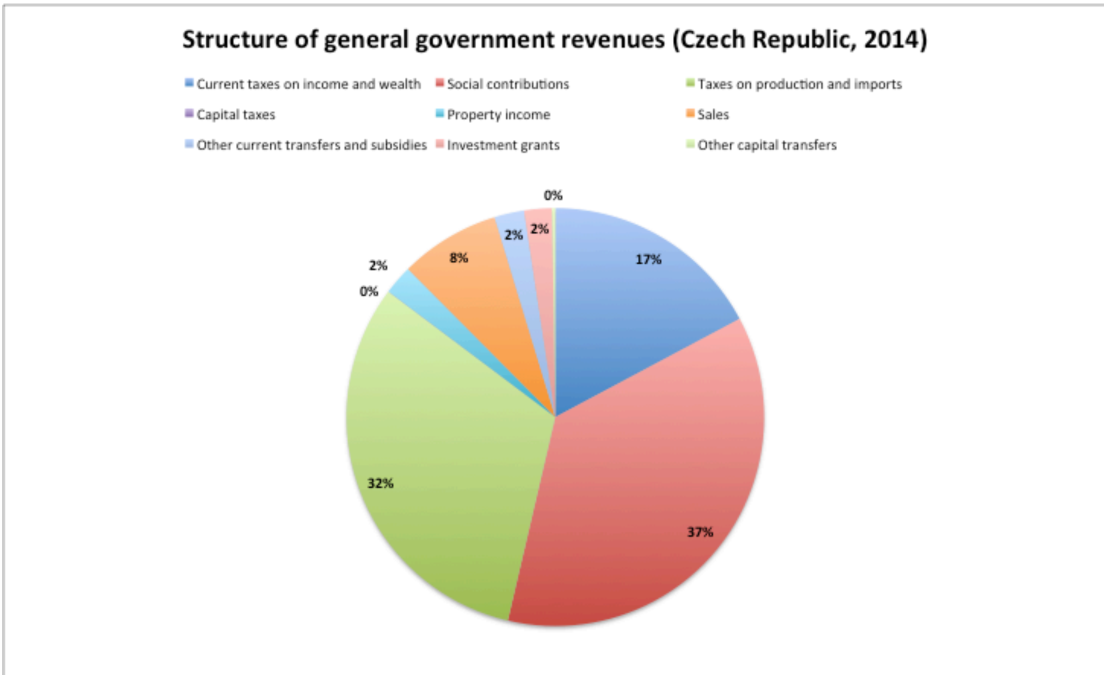
Table 1: International comparison – public expenditures (2006 – 2014)

Public expenditures / GDP	2006	2007	2008	2009	2010	2011	2012	2013	2014
EU28	45,6	44,9	46,5	50,3	50,0	48,5	49,0	48,6	48,1
EA	46,0	45,3	46,5	50,6	50,5	49,0	49,6	49,5	49,1
Czech Republic	40,8	40,0	40,2	43,6	43,0	42,4	43,8	41,9	42,0
Germany	44,6	42,7	43,5	47,4	47,2	44,6	44,2	44,3	43,9
Hungary	51,9	50,2	48,9	50,8	49,8	49,9	48,7	49,8	50,1
Poland	44,7	43,1	44,4	45,2	45,9	43,9	42,9	42,2	41,8
Slovakia	38,5	36,1	36,7	43,8	42,0	40,6	40,2	41,0	41,8

Note: ESA methodology. Data source: Eurostat.

The structure of general government revenues of the Czech Republic is displayed in the graph number 3. The highest volume of revenues (37 %) is generated by social contributions paid by both employers and employees. Taxes on production (esp. VAT and excise duties) create 32 % of revenues, while income taxes generate just 17 % of all revenues. The level of social contributions receivable is significantly higher in the Czech Republic than in other V4 countries.

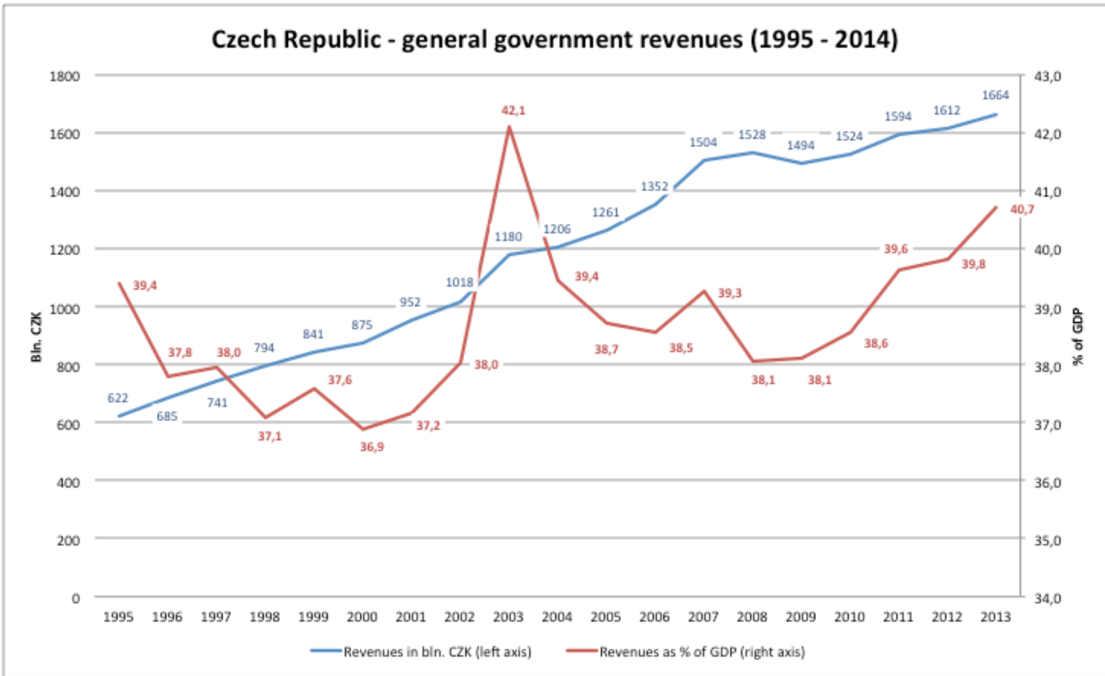
Graph 3: Structure of general government revenues (2014)



Data source: Ministry of Finance, Czech Republic.

The graph number 4 shows a development of general government revenues between 1995 and 2014. The volume of public revenues rose very significantly (+5.7 % annually) as well as a trend of the revenues/GDP ratio. Fluctuations – especially in 2003 – are caused by economic cycle. As mentioned before, a high proportion of social contributions as a principal factor of taxation of labor is critically discussed quite often, however, no government has found political courage to change the tax system. The system is – obviously – too complicated, with thousands of pages of legislation, tax exceptions, progressive (income tax) and regressive (quasi taxes) elements, which negatively influences ability to control tax liabilities and to collect prescribed taxes as well.

Graph 4: General government revenues (1995 - 2014)



Data source: Ministry of Finance, Czech Republic.

The table number 2 shows the international comparison of V4 countries plus Germany and averages of both European Union and Euro Area. All V4 countries, except of Hungary, hold the relative level of revenues below the EU and EA averages. The Czech Republic – again – reports the second lowest numbers; from the perspective of general government revenues on GDP, Slovakia has the minimal state.

Table 2: International comparison – public revenues

Revenues / GDP	2006	2007	2008	2009	2010	2011	2012	2013	2014
EU28	44,0	44,0	44,0	43,6	43,6	44,0	44,7	45,4	45,2
EA	44,6	44,7	44,4	44,4	44,3	44,9	46,0	46,6	46,7
Czech Republic	38,5	39,3	38,1	38,1	38,6	39,7	39,9	40,8	40,1
Germany	43,0	43,1	43,5	44,4	43,1	43,7	44,3	44,5	44,6
Hungary	42,5	45,2	45,3	46,2	45,2	44,4	46,4	47,3	47,6
Poland	41,1	41,2	40,8	37,9	38,2	39,0	39,2	38,2	38,6
Slovakia	34,9	34,1	34,3	35,9	34,5	36,4	36,0	38,4	38,9

Note: ESA methodology. Data source: Eurostat.

It is clear that expenditures higher than revenues mean nothing but negative deficit, i.e. the increase in public debt. Before 1995 and 2014, no V4 country reported net lending in the public finance in any of analyzed years. The total average of annual net borrowing of general government for V4 countries within the time period is -4,7 % of GDP; Czech Republic and Poland are below the average. The table number 3 shows the development of public debt and with respect to the information above it is not really surprising. The public debt of the Czech Republic has risen rapidly in past 10 years (+14,4 p.p.), although the level of indebtedness is the lowest one from analyzed countries. Hungary has to deal with the highest debt – it reached almost 77 % of GDP in 2014.

Table 3: International comparison – general government gross debt (% GDP)

Debt / GDP	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Czech Republic	28,5	28,0	27,9	27,8	28,7	34,1	38,2	39,9	44,6	45,0	42,6
Hungary	58,8	60,8	65,0	65,9	71,9	78,2	80,9	81,0	78,5	77,3	76,9
Poland	45,3	46,7	47,1	44,2	46,6	49,8	53,6	54,8	54,4	55,7	50,1
Slovakia	40,6	33,8	30,7	29,8	28,2	36,0	40,9	43,4	52,1	54,6	53,6

Note: ESA methodology. Data source: Eurostat.

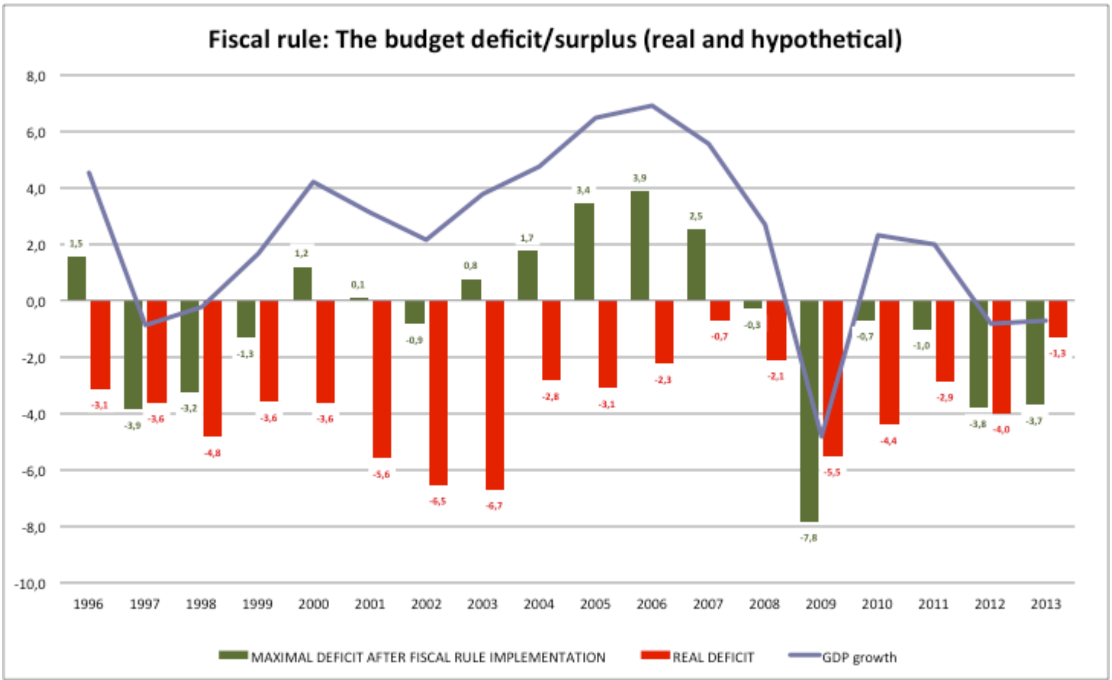
4. Consolidation

As far as the real consolidation of public finance has not been implemented yet in the Czech Republic, this chapter could be the shortest one. To avoid it, I am going to share some experiences of the National Economic Council and its proposal on this issue.

During last 20 years, many politicians, economists, journalists and others debated, lectured or wrote about a necessity of public finance consolidation. Due to the high relation of mandatory expenditures (i.e. expenditures guaranteed by legislation), a way through consolidation of significant expenditure chapters of public budget seemed to be the best possible choice. Nevertheless, there has been no long-term and meaningful reform in areas like bureaucracy and administration of public sector, health system and education, police, army, or pension system. The pension system, for example, was reformed in 2013 by implementation of the 2nd pension pillar, but the then governmental opposition immediately discredited it and announced its cancelation after elections. Therefore, a very low interest to participate had been registered. And, the cancellation of the reform was truly agreed during the last year. All attempts to consolidate “shipwrecked” on weak governments and “unsuitable” economic conditions. Fiscal adjustments have been limited to non-complex policies like accounting tricks (binding for budget planning) or one-shot expenditure cuts, followed by "Peltzman effects" and successive increase of expenditures to the same (or higher) level.

It was clear and it is clear that politicians, suffering from information asymmetry in comparison with bureaucrats, are not able to lower the public finance intervention spontaneously. That is why the National Economic Council, advisory body to the Czech Government, proposed an implementation of an automatic stabilizer of public finance – the fiscal rule. The rule should respect the "Keynesian" idea of fiscal surpluses during economic booming and possible fiscal deficits during economic downturns. According to the proposal, the budget should be planned with respect to the maximal gap between growth of real GDP and the deficit of public finance at the level 3 percentage points [*GDP (%) – deficit (%) = 3 p.p.*]. The prognosis of GDP would follow a colloquium of distinguished institutions from public sector (ministries, national bank…), private sector (banks, consultant firms) and academia (universities), both domestic one and foreign one.

Graph 5: Fiscal rule proposal



Data source: Ministry of Finance and the Czech Statistical Office, Czech Republic.

On the graph above, there is a GDP growth (dark curve) and the real deficit of the Czech public finance (red columns). Especially between 2002 and 2007, the fiscal policy was not respecting the economic cycle. The implementation of proposed fiscal rule would lead to the green reality, i.e. to surpluses during upturn of the Czech economy. The fact is that the rule, no matter if this one or modified one, would tide hands of politicians and their bureaucrats and secure that the fiscal performance would not break away from economic performance. Unfortunately, the proposal has been rejected during negotiations with the government and the ministry of finance.

5. Conclusion

The recent government of the Czech Republic, leaded by the Prime Minister Bohuslav Sobotka (social democrat), declared that after years of "fiscal starvation", the economy must get a significant impulse in the form of public expenditures, public investments and higher number of public procurements. However, the brief fiscal outlook above shows there is no fiscal starvation. Contrariwise, public expenditures rise, the gap between revenues and expenditures is still in red numbers, which means cumulating of deficits.

Without the real consolidation of public finance, no improvement of the recent situation is possible. But, in the environment of rationally ignorant voters, weak politicians and very strong bureaucrats (maximizing their utility by maximizing budgets of their bureaus), the only way how to consolidate public finance in the Czech Republic is a powerful legislative norm, which bans spontaneous enlargement of public finance, i.e. of public sector. After that, particular reforms of pension system, education or health system will not be just possible, but essential.

6. Data sources

- Czech Statistical Bureau
- Eurostat
- Ministry of Finance of the Czech Republic