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Present and Future Fiscal Policy Problems in the Czech Republic

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Contents

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Implicit Risks of Development of Public Finance in Transition

by Pavel Štěpánek

Abstract

This paper is focused – using the example of the Czech Republic since 1993 – on a description of the hidden risks, implicitly existing in the system of public finances during the transition period (from a centrally planned towards market economy). The starting assumption is that public budgets have in time of economic transition certain specific functions. These consist explicitly in supporting the transitional process by transferring part of the economic and social costs, attached to it, over time and various categories of population. These functions are to be carried out at time, when the economic performance of those countries tends to be rather poor and the revenue side of the budgets is not buoyant. Since the financial capacity of the budget is restraint, governments try to find ways by which transition functions could be carried out while their financing would not take the form of instant cash outlays.

Evidence of the Czech Republic suggests that measures, conceived to meet the expectations attached to the budget in respect to part of the transitional costs, though conceived originally as temporary, tend over time to become of a permanent nature. Issues such as a risk of moral hazard then occur.

The analysis also points to the fact that these sorts of phenomena may not be the only factor that contributed to the deterioration of the Czech public finance in recent years.

The evidence of fiscal developments in quite a number of transitional economies suggests that elements of these features tend to exist in most of those countries.

1. Statement of Facts

From the very first days of the independence of the Czech Republic its fiscal policy was characterised by a relatively high standard of discipline. It applies mainly to respecting two principles: the principle of drawing up the state budget with revenues balancing the expenditures and the principle of gradual reduction of the size of government in terms of projected revenues' and expenditures' share in GDP. The public budgets in the first three years posted consolidated surpluses ranging from CZK 27 bn in 1993 to less than CZK 5 bn in 1995, i.e. from 2.6% to 0.4% GDP [1]. From 1996, however, the rate of deficit has been increasing gradually up to roughly CZK 20 bn in 1997 and CZK 43,5 bn in 1998, that is to say up to 1.2% and 2.4% GDP, respectively.

The relatively small internal debt was manifested in low cost of debt service. With the GDP growth, the rate of the officially published gross public debt declined from 19% in 1993 down to 13% in 1997.

Structural disproportions lurked behind the overall relatively favourable results. Surpluses of current revenues compared to non-investment expenditures were decreasing in the public budgets. A decrease was recorded also in the share of investment expenditures in both the total budget and GDP. Significant problems start to cumulate in the state budget itself.

Since 1997, a deficit on the so-called pension account has appeared as a new phenomenon, following a reduction in social insurance contribution rates. The growing share of social expenditures and mainly pension benefits has started to pose the continuous budgetary trap. The inclusion of other mandatory items (such as liabilities related to the Czech Republic's joining the NATO) made even narrower the already limited space to cover the remaining budgetary needs. Indebtedness of cities and municipalities accelerated. The declared budget discipline per se did not ensure an actual fiscal discipline. A number of potential liabilities of the state, and inherent fiscal risks in regard to the stability of public finances were either removed outside the budget system altogether, or the act of resolving them was put off for a later time.

Until now the budgets did not clash with reference values of the Maastricht convergence criteria as regards rates of deficit (2–3% GDP) and of indebtedness (13% officially, but estimated at roughly double that figure when hidden debts are included). Yet

[1] Using IMF Financial Statistics; consolidated balance is adjusted for net lending minus repayments within the governmental sector framework.

open and hidden problems manifested themselves more acutely when economic growth ground down to a halt and downturn occurred with accompanying revenues slowdown and undiminished demand for increased budget expenditures. The drastic budget cuts as executed by the 1997 austerity measures were but a one-time solution which worst impacted the capital expenses chapter with multiplying effects on slowing down economic growth. Deeper reforms with long-term effects were not possible to bring about in such a brief period and they continue to constitute an open, unanswered challenge.

As compared to other transitional economies the Czech Republic has maintained a relatively stable budgetary position and high level of budgetary discipline, particularly as regards the state budget. At the same time, however, financial discipline within the whole system of public finances was substantially looser – from 1996 the whole system recorded deficits. The state budget has traditionally been set to balance revenues and expenditures even though the out turn has been a modest deficit since 1997. Only in 1999, was the state budget drawn up for the first time with a planned deficit, amounting to 1.7 % of GDP (and 2.6 % of GDP for total public budgets).

Table 1. Developments of the State Budget in 1995–1998 and in 1999 (in mil. of CZK)

Indicator	1995	1996	1997	1998	1999 approved	1999 revised
Revenues	439,968	482,817	508,951	537,411	574,112	552,650
Expendit.	432,738	484,379	524,668	566,741	605,127	599,995
Balance	7,230	-1,562	-15,717	-29,330	-31,015	-47,345

Table 1 provides a description of the developments of the state (central) budget. The system of public finance in the Czech Republic comprises naturally an extensive number of additional components, such as district and municipal budgets, several extra-budgetary funds (including the so-called National Property Fund). All these budgetary units would have to be incorporated into the calculation of the balance of general government fiscal activities. The overall picture of the public finance system would then appear in an even worst light.

The main concluding statement based on the time series of aggregate budget figures can be formulated as follows: foundations of the negative trends (including the growing imbalance of public budgets) have been laid down in past years but adverse features of these trends can be seen more clearly only at present. Moreover, those trends may be prolonged even in the next medium-term period.

2. Classification of Factors

Now when we have established the quantitative framework of the development of the budget situation it is important to identify factors that are or may be contributing to the permanent deterioration of the balance of fiscal activities. Though they are quite numerous, the most important could be identified and classified as follows:

1. Disproportions at the revenue and expenditure sides of the budget.
2. Atomisation of the public finance system.
3. Existence of "grey" zones of activities that formally lie outside the public finance system but whose activities are guaranteed and balances paid for by the state.
4. Existence of contingent liabilities in the form of guarantees issued by public authorities (central or even local governments, budgetary or even extra-budgetary funds etc).

2.1. Disproportions at the Revenue and Expenditure Sides of the Budget

These disproportions are leading, among other things, to asymmetric reactions of the revenue and expenditures to fluctuations of the business cycle. They consist namely of:

2.1.1. On the Revenue Side

Inadequate performance of taxation system, autonomously declining tax quota, driven by the following facts:

1. Definition of the tax base, where two problems occur mostly:
   - part of taxes (excises) are defined ad valorem (is attached to the natural consumption);
   - for income taxes, the tax base is very volatile (fluctuations of real wage increases, volatility of corporate profits depending of several factors etc).
2. The tax base is being continuously eroded since the new tax structure has been implemented 1993, both in terms of:
   - population of tax-payers (aging of population, restructuring of the industrial and service sectors etc);
   - accounting definition of the base for the calculation of due taxes.

2.1.2. On the Expenditure Side

The problem lies in the so-called mandatory expenditures, namely:

1. High share of the so-called mandatory expenditures in the total volume of the state budget expenditures:
   - it relates mainly to social welfare expenditures, but;
   - public budgets or state budget are burdened also by other mandatory expenditures; in particular, growth of debt service expenditures (interests and fees) seems to be a risk factor and it can accelerate in case of getting into large-scale debts.
2. Indexation of the most relevant components of mandatory expenditures.

2.2. Atomisation of the Public Finance System

Compared to some other transitional countries, the Czech public finance system may appear as not so much fragmented:

– the fiscal federalism arrangements consist of a three tier budgetary system (central state budget, budgets of districts – about eighty – and then budgets of municipalities);

– moreover, on the revenue side, the fiscal jurisdiction of the lower tiers of governments has so far been extremely limited (practically to the local fees, yet within predetermined limits);

– though districts and municipalities enjoy an extensive autonomy over their borrowing policies, there are strong systemic incentives for them not to abuse of that autonomy;

– the number of extra-budgetary funds is limited and their total quantitative role is (with the exception of the National Property Fund) marginal;

– the public health insurance system is subject to a process of concentration of various funds;

– there exist a number of so-called "transformation" institutions (in substance and for the most part of their activities these are bad-loan hospitals, created in connection with the stabilisation of the corporate and banking sectors), but this number is not so high and those institutions are well controlled by the state (or, alternatively in one case by the central bank);

– there are practically no quasi-fiscal activities of the central bank.

Despite the fact that fragmentation of the public finance system may not be as extensive as in other countries, it still represents a potential risk for the fiscal stability of the country. The problem relates not so much to a number of elements the system contains but how those various elements are managed and controlled. It is also important what power has the government to regulate the balance of their activities. Last but not least, the construction and management of the system of public finance should be subjected to a strong fiscal discipline in confrontation with the basic economic policy choices of the government. If the system does not contain sufficient disciplining provisions, the government may be tempted to underestimate the efficiency argument when deciding to commit the budgetary funds.

From this prospective, the Czech experience provides at least two interesting examples of the absence of disciplining fiscal environment:

a) evolution of temporary "transformation" institutions into permanent ones, combined with an extensive use of their functions to "resolve" issues, for which they were not designed (see section 2.3. of this paper);

b) increasing process of moving present budgetary obligations towards future via sovereign (or similar) guarantees (see section 2.4. of this paper).

2.3. Existence of "Grey" Zones of Activities that Formally Lie Outside the Public Finance System but Have Guarantees of the Government

There are four main so-called "transformation" institutions that have been created in the past in the Czech Republic to address some of the outstanding issues of the economic transition. These are:

– the National Property Fund (agency, primarily founded to technically channel state owned asset to private investors according to privatisation decisions approved by the government);

– the Consolidation Bank (Konsolidační Banka), primarily founded to extend the maturity of and reduce the interest charged for loans, issued in the past to finance part of the working capital of enterprises;

– the Czech settlement unit (Česká inkasní), designed to improve the structure of risk weighted loans at the CSOB (Československa Obchodni Banka – Czechoslovak Commercial Bank, originally specialised in foreign trade financing and carrying over foreign financial activities of the government);

– the Czech financial unit (Česká Finanční), designed by the central bank to assist in the stabilisation of small banks in the Czech Republic.

All of these institutions enjoy implicit guarantees of the government. The impact of their activities on the budget has two dimensions:

a) First, for a given year, net public spending by transformation institutions includes cash outlays on new programs in the form of directed credits and asset purchases and interest expenditures; and is adjusted for debt collection and other revenue from programs and for interest revenue.

b) Second, state guarantees reflect the amount of hidden subsidies and default risk of the guaranteed loans.

There are two distinct periods in the life of the "transformation" institutions:

a) Until 1993, off-budget programs had mainly dealt with pre-transition problems inherited by the banking sector. These programs had been financed through Konsolidační Banka, which was capitalized by the National Property Fund, and borrowed from the Czech National Bank. In 1995, the Ministry of Finance established Česká Inkasní, a non-banking financial institution, to clean-up portfolio of a state-owned bank (CSOB). Covered by a guarantee issued by the National Property Fund, Česká Inkasní took a credit from CSOB and used this credit to purchase CSOB's bad assets at face value.

b) The second phase relates to years 1996–1998, when the new bank consolidation and stabilisation program has been launched in order to deal with the newly emerging problems of the banking sector. In order to implement these programs, the Czech National Bank established Česká Finanční, a non-banking financial institution.

Aside from the bank rescue operations, Konsolidační Banka and, less directly, the National Property Fund has also financed government programs to support troubled insurance companies, public hospitals and the Czech Railways, to build infrastructure, and to clean up industrial enterprises before privatisation. The National Property Fund has partly financed these programs from privatisation revenues but partly also from an issuance of bonds.

The troubling fact about these institutions and their operations under the implicit state guarantee is connected with the rapidly increasing level of contingent public liabilities. These liabilities have been accumulated outside the budgetary system mainly by "transformation" institutions, as they had to borrow in order to finance their activities. Table 2 shows approximate levels of contingent public liabilities, connected with their existence.

Table 2. Contingent Public Liabilities (in CZK bn)

	1993	1994	1995	1996	1997	1998
Konsolidacní Banka (KOB) (net of provisions and reserves)	52	49	30	31	53	85
Cěská Inkasníí (CI) (net of provisions and reserves)		26	26	24	20	18
National Property Fund (NPF)	29	33	40	22	17	15
State guarantees (risk adjusted guarantees outstanding)	3	3	6	28	74	107
Contingent public liabilities (net of provisions and reserves)	**84**	**111**	**102**	**105**	**164**	**225**
Contingent public liabilities (% of GDP) (net of provisions and reserves)	**8.4**	**9.7**	**7.5**	**6.9**	**9.9**	**12.7**
Provisions and reserves of KOB and CI	19	24	42	59	71	84
Gross hidden public liabilities (not adjusted for provisions and reserves)	103	135	144	164	235	309
Reported gross government debt	159	162	154	155	173	210
Reported gross government debt (% of GDP)	15.8	14.1	11.5	10.1	10.5	11.8

Off-budget programs, such as guarantees and support extended through Konsolidační Banka, National Property Fund and other agencies impose cost on taxpayers with a delay but with no discount. As it has already started to happen, past hidden deficits and servicing of the hidden public debt outside the budgetary system gradually generates claims on government budget.

<u>The banking sector remains a major source of claims on government financial support.</u>

There are at present three major banks, still controlled by the state (the sale of the state stake into one of them, CSOB, should to be completed in June 1999). Whether or not activities of these banks have been politically motivated, those large banks residually owned by the state suffer, to various extent, from a weak loan portfolio and continue to rely on state support. The most troubled banks include the Czech Savings Bank and Komerční Banka.

As an illustration of the state support to those bank, the following example is given: in December 1998 Konsolidační Banka transferred CZK 4 bn to the Czech Savings Bank to cover its losses (thus increasing its own losses by CZK 4 bn) and purchased bad assets from Czech Savings Bank in the amount of CZK 6.5 bn. In addition, Konsolidační Banka issued subordinated debt for Czech Savings Bank in the amount of CZK 5.5 bn to help the Czech Savings Bank to meet its capital adequacy requirement. Table 3 shows the worrying development in government exposure to the risks emerging in the three large state-owned banks. In the context of past developments, this table indicates that the process of privatisation of these banks is likely to absorb further public resources, possibly exceeding any revenues realised from their privatisation.

Table 3. Government Implicit Risk Exposure in Large Banks: Amounts of Loss and Classified Loans, 1997–1998 (CZK bn)

	State ownership share	1997		1998	
		Total loss loans	Total classified loans	Total loss loans	Total classified loans
Czech Savings Bank	45.0	33.4	44.7	17.5	41.2
Komercní Banka	48.7	54.1	92.8	30.1	66.5
CSOB	65.7	13.8	27.4	16.3	37.0
Total		101.3	164.9	63.9	144.7
Government exposure (% of GDP)		6.1	10.0	3.6	8.1

Source: Banks' Annual Reports

Altogether, off-budget programs contribute only marginally to achieving main policy objectives of the government and, in some instances, may even undermine these objectives. A brief overview suggests that many off-budget programs, such as bailing out banks and health insurance companies, have done the latter. Sometimes, programs, which did not qualify for budgetary support (for example, an additional subsidy to Railways) did qualify for assistance outside the budget (such as a very risky guarantee extended to Railways). Moreover, these programs have often imply that government will help again in a case of future failures, and thus generate moral hazard among market agents, reducing their incentives to improve productivity and competitiveness. This way, the objective of EU accession and integration with European markets, which poses high requirements on competitiveness of banks and enterprises in the Czech economy, may have been undamaged.

"Transformation" institutions serve the government as the channel of pursuing restructuring programs without much scrutiny and in a costly manner (compared to budgetary decisions). Without Parliamentary and public scrutiny, the government has the authority to pursue programs of all sorts and in unlimited amounts. Since the government guarantees its obligations, for example, Konsolidační Banka is able to borrow in the markets and finance as many programs as requested even though it is unable to repay its debts without future support from the state budget.

The problem with policies, which are not incorporated into the state budget, lies in the minimum transparency of their costs and final fiscal consequences. It manifests itself at five levels as follows:

– The first level involves a macroeconomic problem – that is the sustainability of public finances over the medium term; this is also a problem of the clear identification of the goals and instruments of fiscal and monetary policies and their consequences.

– At the second level this is a political problem of decision-making process regarding the priorities of spending public money. Decisions regarding state interventions and programs implemented outside of the official budget need not necessarily be based on a thorough evaluation of their costs and effects.

– At the third level this involves high costs of implementation and financing programs outside the state budget. This is connected with the problematic supervision of the economical activities and management of the "transformation" institutions and bears on the likely greater costs of their refinancing in comparison with the state debt.

– At the fourth and possibly the most important level this is a problem involving the irresponsible conduct of the banks, enterprises, and other entities and involves the deformation of the markets what results in repeated and, therefore, anticipated financial rescue interventions by the state.

– Finally, at the fifth level, the methods of financing such government policies have varying monetary impacts.

At all five levels, there is the problem of not complete legal and institutional frameworks, which define the adoption, implementation, and financing of government policies outside of the state budget. Therefore, solving the problem of a hidden state debt must necessarily involve the creation of such a legal and institutional framework, which would prevent a further development of such state interventionism, increase of potential state obligations, and its financing outside of the framework of official budget process. This is necessary not only for the support of long-term stability of public finances, but also for correct evaluation of the cost of the individual government programs, facilitating public control of government policies, supporting the efficiency of management of the quasi-budget institutions, which implement such programs, and creating healthy stimuli for the economic agents.

2.4. Existence of Contingent Liabilities in the Form of Guarantees Issued by Public Authorities [2]

Guarantees represent a very dynamic component of the Czech fiscal system and the preferred instrument of government policies since mid of 1990's when fiscal balance went under a pressure. The system of guarantees, issued by public authorities is quite complicated at least in the following respects:

– guarantees are issued by many different authorities at different levels of the public administration structure (central government but also municipalities);

– guarantees are also issued by the off-budgetary funds attached through the balance of their activities to the budget;

– while there is at least some specification of the purpose and limits of state guarantees in the law, applying to activities of the central government, lower tiers are in this respect not regulated at all;

– given the complicated financing channels, used by different "transformation" institutions, there exists an equally complicated system of mutual and multiple guarantees, issued occasionally by those same institutions or the state itself.

The system of guarantees is not well regulated and represents an area, through which a government may avoid the disciplining pressure of the balance of fiscal activities. Almost no statutory and regulatory procedures guide the government's exposure to risks. The government of the Czech Republic has very broad authority to issue state guarantees and accept other off-budget obligations. With respect to state guarantees, the law authorizes the government to extend state guarantees "designed to finance government-approved development programs" without requiring estimates of future potential budget claims and, more broadly, without any public policy framework.

This shortcoming has created an incentive for the spending ministries and budgetary institution unable to secure the desired level of state assistance through the regular budget to seek state assistance through loan guarantees. The additional state assistance provided via guarantees is perceived as cost free and is not included in the overall financial support provided to a given sector (e.g., agriculture and transport). In some cases, guarantees are even extended for purposes that are not authorized under the broad authority of the law. They do not cover development programs, but aim at stabilising the financial situation of the beneficiary.

The amount of issued guarantees is not subject to meaningful limits. The law sets that the sum of instalment payments due within a calendar year cannot exceed 8 percent of

[2] Identified by the Czech government in April 1999.

expected state budget revenues. This limit is extremely high and not very meaningful. For 1999, the limit allows for about CZK 47 bn of instalment payments, compared to the scheduled CZK 12 bn. Other EU applicant countries place much tighter limits on guarantees, such as 1 percent of budget revenues as a limit for new guarantees issued in a given year in Hungary.

Guarantee approval process is weak. Proposed guarantees are presented to the Ministry of Finance by the spending ministries. Then the Ministry of Finance analyses the viability of the proposed project and the borrower's potential ability to repay the proposed guaranteed loan. However, no mechanism encourages the Ministry of Finance to assess a high-risk project as non-viable. Once a project is determined to be viable, it has to be approved by the government. In this process, guarantees are often extended as a result of emergency and eminent political pressure rather than as a result of a strategic decision to support certain outcomes at a given price and against other competing claims on public resources.

The government requires almost no risk sharing by lending institution, which creates a moral hazard problem. As a result of the government's acceptance of virtually all credit risk, the role of the private lending institution is reduced to that of a loan distributor. The lender disregards the credit quality of the borrower. Borrowers tend to neglect risks of projects, which are covered by government guarantee. In the case of default, the borrower negotiates with the government rather than the lender, because the lender does not have a stake in the loan performance. Risks are not properly monitored. The Ministry of Finance provides only limited oversight of outstanding guaranteed loans.

No reserves are set-aside in advance for expected guarantee claim payment. Each year the Ministry of Finance estimates the expected claim payments in the upcoming year. Given the pressure to present a balanced budget, incentives are created to make an optimistic estimate of expected claims in the upcoming year.

The lack of reserves to cover future guarantee claims results in producing "shocks" to the state budget. As guaranteed loans default, resources must immediately be found within the state budget, potentially requiring substantial and unexpected reductions in other state programs.

The lack of a requirement to establish loan loss reserves allows loan guarantees to avoid the discipline of the budget process and creates tremendous incentives to issue guarantees, because they do not require budgetary resources in the current year. As a result, substantially higher budgetary resources may be required in future years to pay for defaulted guarantees. Therefore, the current guarantee structure distorts the decision making process and encourages policy makers to make decisions today that may severely limit the options of future policy makers.

3. Assumptions of Regaining Medium-term Stability of General Government

Identified trends in the public finance sphere demonstrate that deficit will not be eliminated by restoration of an economic growth only although marked improvement of economic performance would somehow modify the above tendencies. In order to restore stability of public finances it is necessary to undertake the following steps addressing their structural weaknesses:

– to carry out reform of the tax system aimed not in increasing the tax rates but at such a change in taxation structure that will lead to an increased elasticity of tax yields related to development of economic fundamentals and, consequently, to improved operation of the tax structure as an in-built stabilizer;

– to undertake the reform of spending programs;

– to assess existing subsidy programs and contain those where purposefulness and efficiency of spending is not demonstrated;

– to accept only programs and projects, comprising calculation of effects, costs and a clear definition regarding resources of their financing either by savings in existing spending programs, or by proposing new resources;

– not to introduce new spending programs that work against the started reform trends and against the need to harmonize spending policies with those of the EU;

– to define clear budget priorities, in order not to allow for their depreciation in the course of budget execution and to concentrate budget funds in a smaller number of high-quality programs; to monitor link-up with requirements presented to the European Commission agencies (co-financing) and NATO;

– to strengthen all forms of scrutiny while concentrating on pre-examination of the proposed projects in the stage of preparation of a draft budget;

– to support program budgeting and fix strictly methodical conditions for inclusion of programs into budgets.

In order to meet the above targets, it will be necessary to develop a comprehensive and well-articulated medium-term fiscal strategy. This is important not only as a part of the EU accession program, but also in order to address the mounting pressures from mandatory expenditure programs and limit fiscal risk associated with the existing contingent liabilities and potential costs of bank privatization and Czech economy restructuring.

The development of medium-term fiscal framework with inclusion of contingent liabilities and off-budget activities into the budgetary process is only a one of the necessary steps. It is also important to be concerned about the looming demographic time bomb that will destabilize the current parameters of the pension system and to initiate, at this very moment, changes in the pension system to make it sustainable.

Comprehensive structural reforms in financial and industrial sectors including their institutional dimension and legal framework are also an inevitable part of restoration of public finance stability. The main problems are as follows:

– survival of large, inefficient and excessively indebted corporations lies at the heart of the current economic malaise with corresponding impact on public finances;

– privatization of banks is central to building an efficient financial and industrial system that should no more burden general government expenditures or make for potential fiscal risks;

– it is necessary to accelerate privatization both of strategic non-financial enterprises and of remaining state owned shares in smaller firms and to pursue maximization of its fiscal effects.

Attachment I
Types of Fiscal Risks

Types of Fiscal Risks to the State	Direct Obligations	Indirect (Potential) Obligations
Explicit obligations	Budgeted revenues and expenditures within the framework of annual budgets such as: Paying off the direct state debt Salaries and other benefits for employees of public administration Expenditures for pensions, health care, and social welfare Expenditures for law-mandated programs	*Losses and obligations connected with the state's assumption of claims within the framework of reorganisation, consolidation, and stabilisation programs accepted by the government* *Losses and guarantees issued by specialised institutions such as the Bank of Consolidation, the Czech Encashment Corporation, and the Czech Financial Corporation* *State guarantees for bank loans made to public and private entities* *State guarantee in favour of the Czech National Bank to support the banking consolidation and stabilisation program* *Losses and unfulfilled obligations of the Export Guarantee and Insurance Corporation and the Czech Export Bank*

Types of Fiscal Risks to the State	Direct Obligations	Indirect (Potential) Obligations
Implicit obligations	Expenditures in future budgets within the framework of long-term capital and other programs such as long-term financial costs to complete and operate public capital programs which have been begun	*Losses and obligations incurred by the Fund for National Property* *Ad hoc promises to compensate private entities for losses based on old government obligations (preferentially treated " social" loans; legally mandated insurance of the responsibility for operating motor vehicles)* *Ad hoc promises of the government to compensate private entities for losses resulting from new obligations (as a result of privatisation or as a result of taking over failing banks and other enterprises)* *CNB losses resulting from claims against the NBS (National Bank of Slovakia) resulting from the breakup of the federation* *CNB losses resulting from loans to clients (state enterprises or enterprises resulting from their privatisation)* Additional financial aid to banks in difficulty Unplanned financial aid to public institutions, for example, to hospitals, schools, and other "public-interest" institutions in difficulty Compensation of losses suffered by the Czech-Moravian Guarantee and Developmental Bank Compensation of obligations (guarantees) provided by the Farmer and Forester Support and Guarantee Fund

Types of Fiscal Risks to the State	Direct Obligations	Indirect (Potential) Obligations
		Compensation of losses suffered by health insurance facilities Assumption of unfulfilled obligations of local and regional governments (financial obligations and obligations to provide certain services) Financial aid for large and economically important enterprises in difficulty (for example, the Czech Railroads or even private important regional employers) Promises to compensate property damage, for example, the CSOB (Czechoslovak Commercial Bank) in its relationship with the Slovak Encashment Corporation or the CP (Czech Insurance Institution) in its relationship with the legally mandated insurance of the responsibility for damage caused by motor vehicles Obligations of loan cooperatives (Kampelicky) Expenditures for eradicating ecological damage State assistance at times of natural disasters In the extreme case, financial assistance to save the stability of the balance of payments, the monetary and payments system (collaboration with the CNB and a possible state guarantee for international stabilisation loans)

Attachment 2 (see page 33)

Fiscal Policy Outlook 1998–2005

by Ondřej Schneider

Abstract

We analyze the Czech fiscal policy outlook. The analysis confirms the truly dire condition of the Czech state budget. Revenues' share of the GDP is plummeting, as corporate taxes decline further and consumption taxes lag behind nominal GDP growth. Expenditures, contrarily, are set to rise; the easy cuts have already been made, social expenditures swell as the population ages, and past debts are slowly maturing. All combined, we foresee deficits of about 5% of annual GDP in the coming years. The state debt would therefore collectively balloon to roughly 60% of GDP within a decade.

1. Czech Fiscal Minefield

Czechs thought that they could have the best of all possible worlds: lowered taxes, balanced public budgets and a decent social security system. They knew it would take a miracle, as these were not mundane goals. When first cracks in the blushing economic facade began to appear, a sophisticated system of hidden, off-budget funds was built. As the 1996 election approached, social security expenditures were stepped up. Now, the whole fiscal system is seemingly headed for a crash/collapse. What comes next? Looking at Czech fiscal policy, we cannot see any easy remedies, as the gap between revenues and expenditures stretch to 5% of GDP. In such times, tinkering at the edge of the disaster offers little and fundamental reforms are needed.

What went wrong? The seeds of the current fiscal tension were planted in the early 90s when the tax system was overhauled and a new social security system established. While tax revenues were tied to the nominal GDP, expenditures have since moved more in sync with nominal wages. This is a common feature of many tax systems in Europe and should not be any problematic. The Czech Republic, however, has meanwhile become famous for its lax corporate governance, a feature of which was rapid wage growth as opposed to aggressive restructuring or layoffs. Thanks to the fiscal system, high wage growth has translated into collapsing corporate taxes, rapidly growing social expenditures and, eventually, to the growing gap between budget revenues and expenditures (see Chart 1).

Problems were kept under wraps for several years. In 1994 and 1995, budget revenues were supplemented by transfers from the National Property Fund (in an amount of about 1% of GDP). The fiscal system was further "augmented" by an excessive system of off-budget funds to which various expenditures had been tunneled without proper consolidation. The official government budgets have thus become very incomplete. We should stress, however, that we have analyzed the future central government budgets only, as off-budget funds are fiendishly difficult to predict as their expenditures are overwhelmingly discretionary and may change dramatically in a very short time.

The system came under attack first in 1996 when the budget slipped into a deficit even when "surplus money" from 1995 was transferred to 1996 revenues. In 1997, the budget accumulated a deficit of CZK 16 bil. (1% of GDP), but only after an enormous effort was devoted to slashing budget expenditures by CZK 40 bil. (2.5%

of GDP!). The 1998 budget was constructed as a restrictive one, and even though the economy contracted by 2.7%, the budget itself showed a deficit of "only" CZK 31 bil. (1.7% of GDP).

We may consider 1998 as the last in a series of "conservative" budgets – when the government sought balanced budgets at almost any price and often played loose with economic logic toward that end. Budgets in 1997 and 1998 were fairly restrictive, as the government eagerly cut expenditures in line with decreasing revenues. The government's share in GDP thus fell by two percentage points in two years. Since 1999, the driving philosophy has changed. A balanced budget is no longer seen as sacrosanct and, meanwhile, accumulated debts emerge. Combined with the aggressive spending plans of the new government, a combustible mix has been produced. The government expenditures' share in GDP will begin to grow again in 1999 and will edge upward in the future. The central government deficit will reach beyond 3% of GDP very quickly and is headed toward a 5% level in the near future.

2. Past: Slowly Growing Deficits

Why do budget revenues under perform expenditures? We have analyzed the past patterns of main expenditure and revenue items of state budgets. Table 1 illustrates the underlying trends: while the current expenditures were growing faster than nominal GDP, revenues lagged by almost two percentage points. The most rapid growth experienced was in social security expenditures, whose growth exceeded nominal GDP growth by six percentage points. So much for radical neo-liberal economic reform in the Czech Republic.… Most laggardly were defense expenditures, which grew by a paltry 3.2% on average, and interest payments, which remained low due to a low level of debt.

The second part of the table dismisses the common notion that tax collection in the Czech Republic was ineffectual and that a shift occurred away from direct taxes. With the exemption of corporate taxes, which were indeed collapsing, the tax collection was quite efficient. Personal taxes grew by a robust 17% annually, as did social contributions. Value-added-tax revenues lagged slightly behind the nominal GDP growth, while excise taxes grew vigorously.

Table 1. The Actual and Projected Date of Revenue and Expenditure Increase (in %)

Nominal GDP Growth	**12.1%**	**9.5%**
Expenditure programs	**Average growth rate in 1993–1998**	**Expected growth rate in 1999–2005**
Defense	3.2%	16.2%
Education	10.7%	9.5%
Health Care	12.9%	10.0%
Social Security	18.3%	10.7%
Capital Expenditures	10.1%	8.4%
Current Expenditures	**12.9%**	**9.6%**
Interest Payments	**4.0%**	**16.5%**
Revenues	**Average growth rate in 1993–1998**	**Average growth rate in 1999–2005**
Personal Income Tax	17.3%	13.2%
Corporate Tax	-5.1%	7.6%
Social Contributions	16.8%	10.6%
Value Added Tax	11.1%	8.4%
Excise Tax	12.6%	6.7% *(14.4%)*
Total Revenues	**10.3%**	**9.2% *(10.0%)***

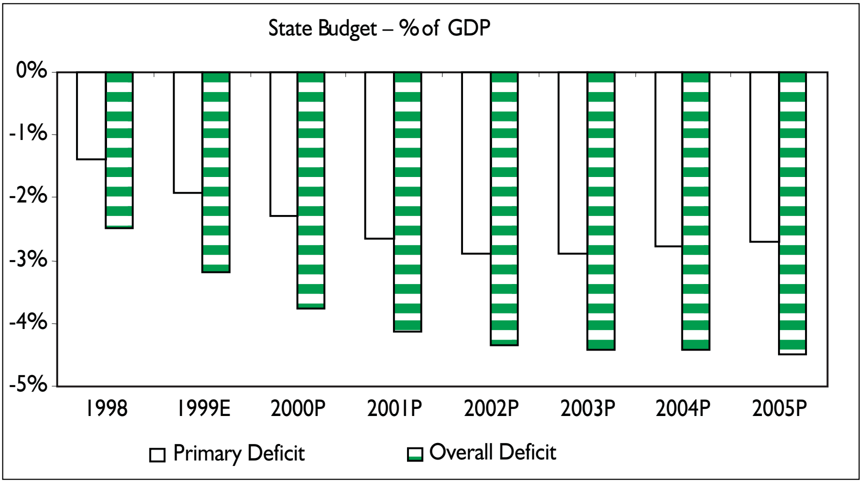
3. Future: Fast Deficits

The future offers a similarly bleak picture. As social expenditure out-paces GDP growth, defense expenditure has to catch up in order to bring them to the level of 2% of GDP pledged by the government. As the state debt will deepen, interest payments will rocket by more than 16% yearly. Taken all together, expenditures will grow by 9.6% over 1999–2005, a shade faster than nominal GDP, slowly increasing the government share from 41% of GDP in 1999 to 42% in 2005.

Budget revenues are expected to grow by 9.2% annually, due to the slow growth in corporate taxes and consumption taxes (VAT and excises). It is significant that personal income taxes represent the most dynamic portion of budget revenues, followed by social contributions, even if we did not include future hikes in social contribution rates as hinted by the government. Higher personal taxes and higher social contributions of course project a further upsurge in the labor tax burden and in a higher rate of unemployment. Budget revenues may be boosted by an aggressive convergence of the Czech excises to the average European level (see below).

Chart 1 provides the fiscal outlook of the central government deficits in a nutshell. We distinguish between primary deficit (before any interest on state debt is paid) and overall deficits, which includes such payments. The primary deficit jumps from 0.5% to 2% of GDP in 1999 and then slowly increases, nearly to 3%, where it hovers between 2002 and 2005 – **if we assume no change in government policy.** As the state debt increases each year, however, interest paid doubles, from 1% in 1998 to almost 2% of GDP in 2005. This would stabilize the overall deficits at around 4.5% of GDP. In nominal terms, such deficits mean that central-government deficits would break the CZK 100 bil. (USD 2.8 bil.) mark in 2002, and reach almost CZK 150 bil. (USD 4.2 bil.) in 2005.

Chart 1. Primary and Overall Deficit of the State Budget, 1998–2005



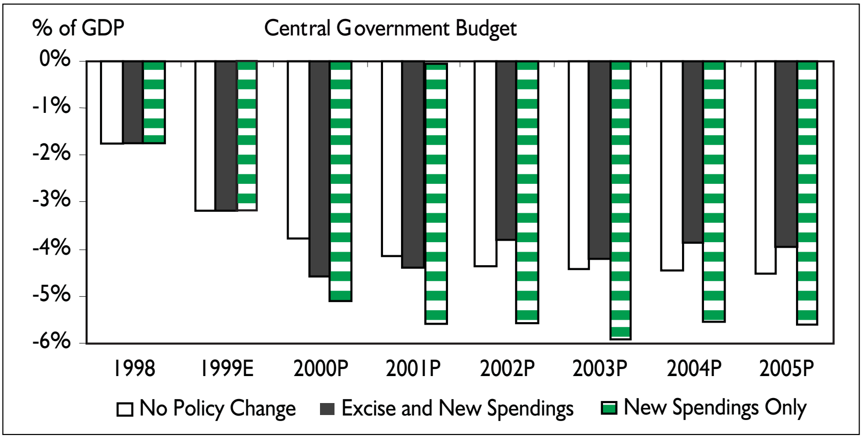
Although the numbers above do not differ significantly from the government's own figures, we are less optimistic that GDP growth will resolve the Czech fiscal conundrum. As long as expenses are correlated with wages and grow faster than revenues, the state budget will find it very difficult to meet its commitments.

4. Some Policy Changes May Worse the Deficits

In our model we have not, thus far, foreseen any change in the government's policy. This is obviously too bold assumption. Therefore, to make such a forecast more interesting, we have added two new features: First, we analyze a couple of new government initiatives that were approved in late April. The Cabinet approved the "Agriculture Sector Strategy" that calls for increased state subsidies to the sector to the tune of 1.3% of GDP (currently it stands at 0.8% of GDP). Further, the "Medium Term Strategy for Transport" was approved. In a rather clandestine way, it foretells financing new programs amounting to 0.5% of GDP. Also, the Ministry of Industry and Trade had its soft-loan and subsidy package approved. These initiatives increase the deficit by a combined 1.0–1.5% of GDP in respective years, bringing it to almost 6% of GDP in 2003. It is interesting how easily and how stealth-like the Cabinet approved programs that so significantly deteriorate the fiscal outlook.

On the positive side, there seems to now be an agreement that excise taxes will be increased to European levels. Currently, they are about two thirds of the target value, therefore, they can be increased by 50% in the course of a few years. That could boost tax revenues by CZK 10 bil. in 2000, by almost CZK 50 bil. in 2003, and even by CZK 60–65 bil. in 2005, thus canceling the effect of the new spending programs described above. Even in such a case, the government deficit would stabilize at a fairly high level of 4% GDP.

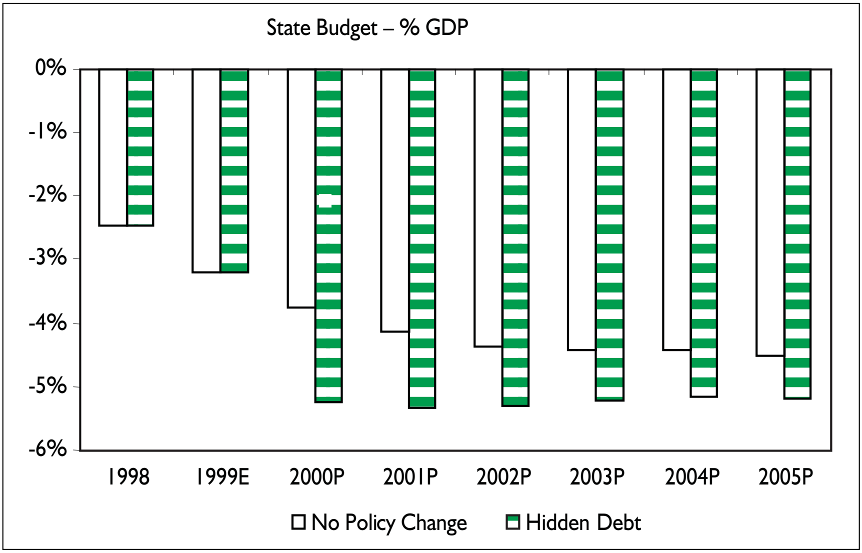
Chart 2. Influence of the Projected Policy Changes on the Future Fiscal Outlook



5. Forgotten Sins?

The current Cabinet must, moreover, one day face the legacy of previous governments that have accumulated the so-called "hidden debts," which will amount, according to the World Bank, to about CZK 270 bil. (15% of GDP) by the end of 1998. The debt consists of the outstanding liabilities of the government's off-budget funds (Konsolidacni Banka, Česká Finanční and Česká Inkasní) and of government-guaranteed loans. The government debt would, in fact, double to 30% of GDP, if we added the hidden debt to the officially recognized debt. According to the Ministry of Finance, the hidden debt will be eventually securitized, so future budget expenditures would incorporate servicing the costs of this debt and would be more predictable. If we conservatively estimate that the government will service only the interest and never retire the debt as such, then the budget expenditures would be increased by approximately 1.5% of GDP in 2000 (see Chart 4). As interest payments remain flat in nominal terms, their share in GDP slowly declines and the yearly overall budget deficits stabilize at around 5% of GDP.

Chart 3. Influence of the Hiddn Debt on the Future Fiscal Outlook

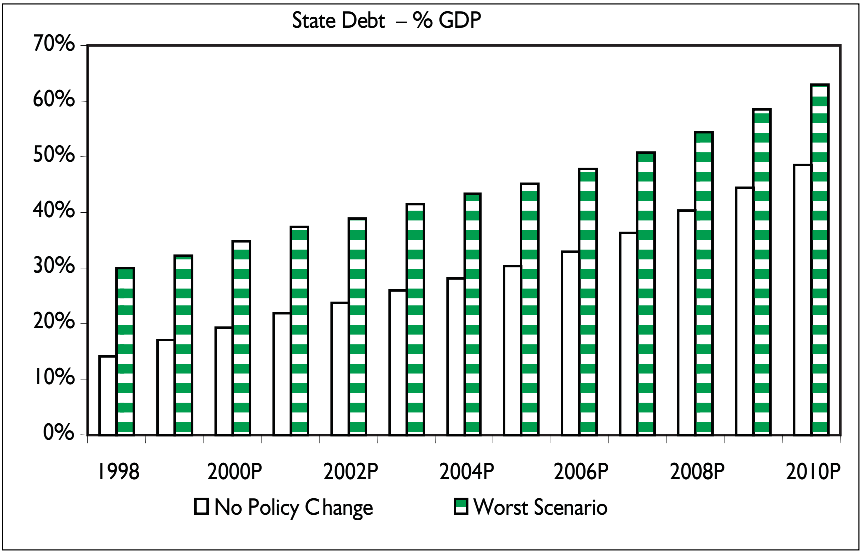


6. Living Beyond our Means (The Unbearable Lightness of Being...)

As we demonstrated, Czech fiscal policy is headed for substantial deficits in the future. Deficits will occur if the government simply extends the current policies and they will be even higher if it adopts some of the recently proposed measures. Moreover, off-budget institutions will, in all likelihood, continue to generate substantial losses in the future. As they are explicitly or implicitly guaranteed by the state, the government budget should better prepare for high and unpredictable expenditures, similar to the CZK 15 bil. required by Konsolidační Banka this year. Therefore, all of our estimates should be taken as an optimistic alternative.

It has been often noted that the Czech Republic has ample room for deficit financing, as its debt is relatively low, even if we allow for the so-called hidden debts. A strategy of aggressive deficit financing would be, however, quite risky. As debt is accumulated, servicing cost balloon, and the government will find it increasingly difficult to slash other expenditures to stabilize deficits. Indeed, as Chart 4 shows, state debt rises relentlessly

Chart 4. Possible Scenarios of the Public Debt



in all alternatives. If we disregard the "hidden debts" and do not change the current policies, the state debt reaches almost 50% in 2010, as compared to a mere 14% in 1998. However, as the "hidden debts" cannot be hidden forever, and the government has pledged to increase spending on some programs, this scenario is far from certain. If, to the other extreme, the government acknowledges the hidden debts, increases spending according to its latest proposals and brings the excise taxes to European levels, the state debt will expand from 30% to more than 60% in the same period.

Quagmire

The fiscal outlook is thus scary/quite terrifying. Even though our analysis has left out the future annual deficits of all "transformation" institutions – and we have not contemplated pension reform – we have identified deficits of about 5% of GDP each year that are already in the pipeline. Such a relaxed fiscal policy would accumulate debt amounting to 50–65% of GDP in just a decade. The experience of other countries (Belgium, Italy, …) shows that this would certainly lead to higher cost in the future, when the interest is paid, without necessarily improving the economy's competitiveness or the welfare of the citizenry.

139	Роберт Брудзыньски, Малгожата Маркевич, Экономические реформы в Кыргызстане в 1997-1998 гг.(September, 1998)
140	Емир Джугели, Ираклий Гварамадзе, «Нулевые» аукционы: цели и анализ результатов (September, 1998)
141	Приватизация за любую цену. Анализ опыта Республики Грузия в 1997–1998 годах. Под редакцией Влодзимежа Панькува и Барбары Гончаж
142	Ирина Синицина, Марек Ярочиньски, Бюджетно-налоговая система и государственные финансы Грузии в 1997–1998 гг.
143	Michał Górzyński, Privatization in Romania
144	Robert Brudzyński, Investment Risk in Branches of the Kyrgyz Economy
145	Magdalena Tomczyńska, Ewa Sadowska-Cieślak, Zmiany w polskim systemie finansowym w ramach przygotowań do integracji z UE
147	Krzysztof Rybiński, Mateusz Szczurek, Current Account – Inflation Trade-Off. Lessons for Poland and Other Transition Economies
148	Urban Górski, The Interbank Money Market in Ukraine
149	Jarosław Neneman, The Reform of Indirect Taxation in Hungary, the Czech Republic, Poland and Romania
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155	Jacek Cukrowski, Jarosław Janecki, Financing Budget Deficits by Seigniorage Revenues: the Case of Poland 1990-1997

158	M. Dąbrowski (ed.), M. Dekhtiarchuk, U. Górski, P. Kovalev, Y. Kuz'min and K. Sultan, Ukraine: From Fragile Stabilization to Financial Crisis
159	M. Dąbrowski, U. Górski, M. Jarociński, Inflationary Consequences of Devaluation Crises in Russia and Ukraine: The First Observations
161	Magdalena Tomczyńska, Comparative Analyses of Direct Tax Systems in Selected Central European Countries: Poland, Czech Republic, Hungary and Romania
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167	Ondrej Schneider, Implicit Public Debt of the Czech Social Security System
168	Marek Styczeń, Socio-demographic Forecast of Poland, 1997–2050, for Modelling Incomes and Social Security Retirement Pensions
169	Joanna Siwińska, The External Public Debt of Baltic and Selected CIS Coutries in Year 1992–1997, Estonia, Latvia, Lithuania, Kazakhstan, Kyrgyz Republic, Moldova, Russian Federation and Ukraine
170	Gerhard Fink, Peter R. Haiss, Lucjan T. Orlowski, Dominick Salvatore Privileged, Interfirm/Bank Relationships in Central Europe: Trigger or Trap for Corporate Governance?
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