

# Fiscal Imbalance Problem and Public Finance Reform

Czech Case

3rd Lecture

Transformation of the Public Sector

## Content of Lecture

1. Fiscal Imbalance Problem
2. Public Budget Reform

## Fiscal Imbalance - definition

- fiscal imbalance occurs in situation when budget revenues differ from budget expenditures in certain period (budget year)
- revenues > expenditures → surplus
- revenues < expenditures → deficit

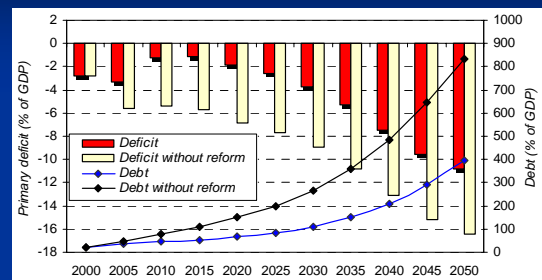
## Primary x secondary deficit

- Primary deficit is created in certain budget period (year) and expresses growth of public debt due to government fiscal policy and (or) exogenous factors (exception – interests from the public debt).
- Total deficit = primary deficit + interests from the public debt.
- Secondary deficit arises in connection with financing of public deficit (e.g. bonds,...)

## Characteristics of Czech fiscal system

- Czech fiscal system is extremely vulnerable to demographic pressures ([graph](#))
- pro-cyclical features of Czech fiscal system (cyclical x non-cyclical factors)
- deficits have structural character, not cyclical
- transparency of the fiscal system is insufficient
- size of off-budget operations is not negligible → transformation institution, state funds

## Graph: Primary Deficit and Public Debt



Source: Czech Ministry of Finance.

## Basic thesis of the Czech Reform

- situation before setting up the reform was not sustainable for a long time
- continued decreasing of the public deficit in order to Maastricht criteria
- maintenance of width and quality of provided services
- preference in changes on expenditures side rather on revenues side of public budgets

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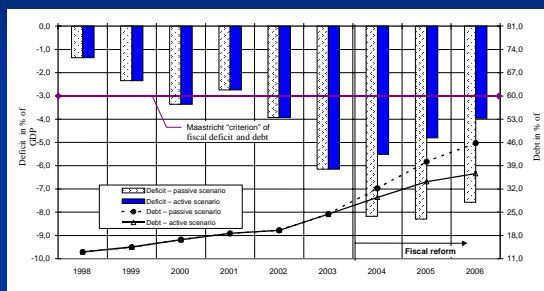
## Public Budget Reform

2 stages of the Czech Public Budget Reform:

1. Stage – main goal:
  - bring the deficit trend to a stop
  - slowing down the dynamics of public debt increase;
2. Stage – main goal:
  - fiscally-neutral tax package for enhancement of economic growth
  - preparation of pension and health care reform

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Graph: Development of deficits of public budgets and public debt (without obligations of the Czech Consolidation Agency) in the passive and active scenarios



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## Targets on the revenue side

- stabilization and maintenance of tax-quota (around 40 %)
- harmonization with EU tax-law
- restriction of tax evasions together with increasing of tax justice
- simplicity of tax-system and levy of taxes

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## Value Added Tax

- decreasing of the standard rate VAT to 19 %
- transfer of certain goods and services to the standard rate according to EU (e.g. internet, telecommunication services, lawyers, hair-dressers, cleaning services, ...)
- transfer of some goods to reduced rate (e.g. coffee, tea, chocolate, chewing gums ...)
- transitory provisions for heat supplying and construction of buildings for living
- transfer of hotel services to reduced rate until the end of the year 2005 (together with fees to sport actions and museums)
- continued turnover limit for mandatory registration to VAT (€ 30 000)

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## Excise Duties

- increase of rates up to level of minimum rates applicable in EU
- introduction of a suspension arrangements with so-called tax warehouses
- gradual attainment of 57 % tax burden on cigarettes by 31 December 2006
- tax imposed on ethyl alcohol related to homemade spirits stays on 50 % (permanent exception)
- sale of tobacco and spirits on marketplaces is prohibited
- marking of spirits by control labels

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## Income Tax

- the corporate income tax should be reduced from 28 % (January 2004) to 24 % (January 2006)
- the “minimum tax” was set
- partial broadening of tax base – setting of a price limit for depreciation of acquired cars to CZK 900 000 since 2004
- taxation of individuals not go through significant changes in 2004 – 2006, only deductible item for children is raised by CZK 2000

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## Estate Tax

### Real Estate Tax

- new legal regulation → the tax on land is transferred in full to a value principle, without participation of experts or assessors → reducing the total cost of this tax administration

### Real Estate Transfer Tax

- tax rate is reduced from 5 % to 3 % (1 July 2004)
- certain exemptions concerning this tax was cancelled

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## Other Taxes

### Inheritance Tax

- the inheritance in the group I of heirs is exempted from the tax

### Local Fees

- transformation to municipal taxes
- the range of municipal taxes will be extended if need be

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## Tax Administration

- taxes and tax control → new process regulation, the so-called tax code
- obligation to register cash payments by means of cash registers on marketplaces or through stall sales
- the bookkeeping of the VAT non-payers will be simplified

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## Social and Health Insurance

- canceling of the transport allowance for students
- unlimited possibility to have gainful employment together with obtaining parent's contribution
- incomes from student's summer jobs will not be counted to total income of family → family will not lose social benefits
- the assessment base of self-employed persons for both type of insurance will be increased from 35 % (2004) to 50 % (2006)

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## Social and Health Insurance (2)

- the principle of a fictive income in the amount of 50 % of the average wage in the national economy will be applied → establishing minimum income tax, calculation of a minimum payment of social security insurance premium and state employment policy contribution, minimum assessment base for the health insurance and for evaluation of the entitlement to social benefits

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## Expenditure Side

financially very demanding programs following from the declared government's priorities (e.g. R&D, education, transport infrastructure, programmes co-financed from the EU budget)

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government engaged itself to stabilize the public budgets (together with rationalism of mandatory expenditures, emphasis on program-oriented structure of the State Budget)

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## Pensions

Current pension insurance scheme is financially unsustainable in the long term, modifications:

- the age limit for retirement will be increasing until reaching the equal level of 63 years for both man and woman (2013)
- the possibility of a temporary reduction of the old-age pension at pre-mature retirement is cancelled (the permanent reduction remain)
- unlimited earnings for pensioners
- suggestion of the Pension Insurance Scheme Reform → transition from the benefit-defined system to contribution-defined system (NDC – Sweden model)

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## Sickness Insurance

Aim → to prevent misuse and deformation of effects of the system:

- the decisive period for the determination of the assessment base is prolonged from 3 to 12 months
- reduction of the assessment base for the time of the first 14 days of sickness from 100 to 90 %
- for the first three calendar days of sickness the amount of sickness pay is reduced to 25 % of the daily assessment base

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## State Social Assistance and Social Welfare Benefits

- necessity of quick and deep reform → intensive targeting of benefits to those in need
- increasing motivation of participants
- revision and reduction of state social assistance benefits and social welfare benefits
- reconstruction of the subsistence minimum
- conditions should generally be stricter and control of the benefit payments more intensive
- separation of the roles of the state and territorial self-governing units

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## Public Health Insurance

- necessity of reform because of financial demands on public health insurance system connected with ageing of population
- regulation, cost control and increase of effectiveness of management of the health care facilities → regulating of expenditures
- implementation of a payment for diagnosis in the bed care segment
- regulation of expenditures for medicaments

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## State Assistance to the Building Savings

- state support of the building savings decreased from 25 % to 15 % of the annually saved amount (assisted maximum increased from CZK 18 000 to CZK 20 000)
- extension of the five years' binding period to six years
- provision of the state assistance to the participants who reach 15 years of age

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## Public expenditures Management

- maintenance of aggregate fiscal discipline
- allocation efficiency – allocating of sources in order to government priorities
- economic efficiency – support of effective providing of services

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## Improvement of Public Expenditures Management

- medium-term budgeting – 3 years horizon
- implementation of expenditure frameworks
- programme financing instead of budget financing
- expenditure audit
- centralization of certain purchases in the public sector and usage of PPP (Public Private Partnership)
- reduction in the total number of employees in the centrally controlled public services by 6 % till the year 2006

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## Risks of the Reform's Realization

- insufficient support → Government, across the political scene, laic and professional public, media → necessity of transparency
- fragmentation of public budgets → consolidation of expenditures ceilings, local budgets, state funds, transformation institutions
- “new skeletons” → debt of the past, state guarantees, ...
- political factors → inclination of politics, elections in 2006 (or earlier?)

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## Risks of the Reform's Realization (2)

- adaptation of the chapter administrators to new challenges → internal competition in given financial sources, qualitatively different environment
- Human resources → many government employees are responsible for creation, realization, monitoring and evaluation of the State Budget → necessity of continuous professional training, co-operation with appropriate faculties of Czech universities

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## The Main Issues of the 2<sup>nd</sup> Stage of the Public Finance Reform

- support of families with children (shared taxation of married couple, child allowance)
- commerce support (accelerating of amortization in 1. – 3. class)
- support of science (increasing of limits for gift depreciation)
- fight with tax evasions (control labels on spirits, limitation of cash pays, cash registers ...)

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## The Approach of ODS

- principal changes of the economic policy
- environment favorable for business activities
- “small” state (limitation of bureaucracy)
- deep changes in social system (cancellation of benefits, principle of negative tax) and pension system (minimum pension guaranteed by state + individual savings)
- unification of the tax rates to 15 % (VAT, Income Taxes)

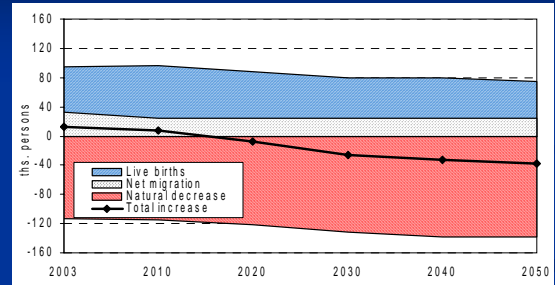
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## The Approach of ODS (2)

- health insurance reform
- deregulation of rentals
- rationalism of legislative
- rationalism of public institutions
- consolidation of public budgets
- fixation of proportion of consolidated expenditures on GDP
- obligation of balance budgets (except of the State Budget)

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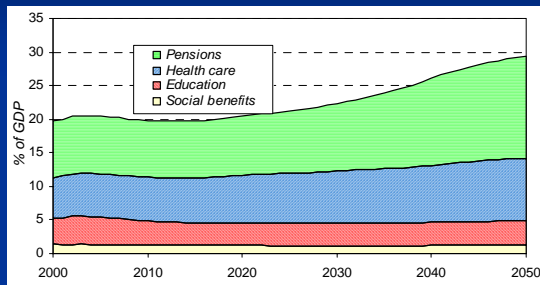
### Graph: Structure of Demographic Development



Source: CSO.

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### Graph: Development of Individual Age-Dependent Expenditure Items.



Source: Czech Ministry of Finance.

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The End 😊

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