Fiscal issues and central bank policy in the Czech Republic

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1. Introduction

Macroeconomic analysis in the Czech Republic in recent years has increasingly focused on fiscal policy. The reason is the deterioration in the Czech public finances, which has a structural character rather than being caused by the business cycle. These fiscal policy developments have significant consequences for the implementation of monetary policy.

A fiscal analysis that evaluates in more detail the effect of fiscal policy on economic and monetary developments therefore enables more effective coordination of monetary and fiscal policies. In particular, fiscal developments significantly constrain monetary policy strategy and affect the timing of the adoption of the euro. Against this background, this paper describes some of the characteristic features of fiscal policy during the Czech Republic's economic transformation since the start of the 1990s.

2. Economic transformation and fiscal policy

We can divide Czech fiscal policy during the economic transformation into two basic phases. The first period, roughly from 1993 to 1998, could be characterised as "conservative" fiscal policy that aimed at achieving a balanced state budget and a reduced role for the state in the economy. In the second phase, running from 1998 up to the present, fiscal policy has conversely been directed at strengthening the state's role in the economy. One of the consequences is a growing public finance deficit. The widening deficits of the general government budget now place at risk the achievement of economic and monetary policy objectives.

In the period 1993-98, the government's fiscal policy was directed towards establishing a legislative and technical framework comparable to that in modern market economies. This entailed implementing a series of fundamental measures as part of the ongoing economic reform process. In the public finance area, it involved, for instance, introduction of a completely new tax system from January 1993 and an explicit fiscal target of no increase in the nominal state debt (implying a decrease as a ratio to GDP). There was an intensive political and economic debate about establishing a legislative requirement for balanced state budgets, but the proposals were not accepted by the parliament.

Since 1998, the government's fiscal policy has been based on other, often opposite, priorities than in the foregoing period. Although the original fiscal policy target for the period 1998-2002 was the maintenance of balanced public finances, in 2002 the government openly opted for promoting economic growth by means of public budget deficits. Some special off-budgetary institutions were established to carry out public investments in certain areas. This decreased the control of the ministry of finance over the overall development of the public finances and led to a further fragmentation of government budget structure. Graph 1 shows the different trends in the development of the public debt in these two periods.

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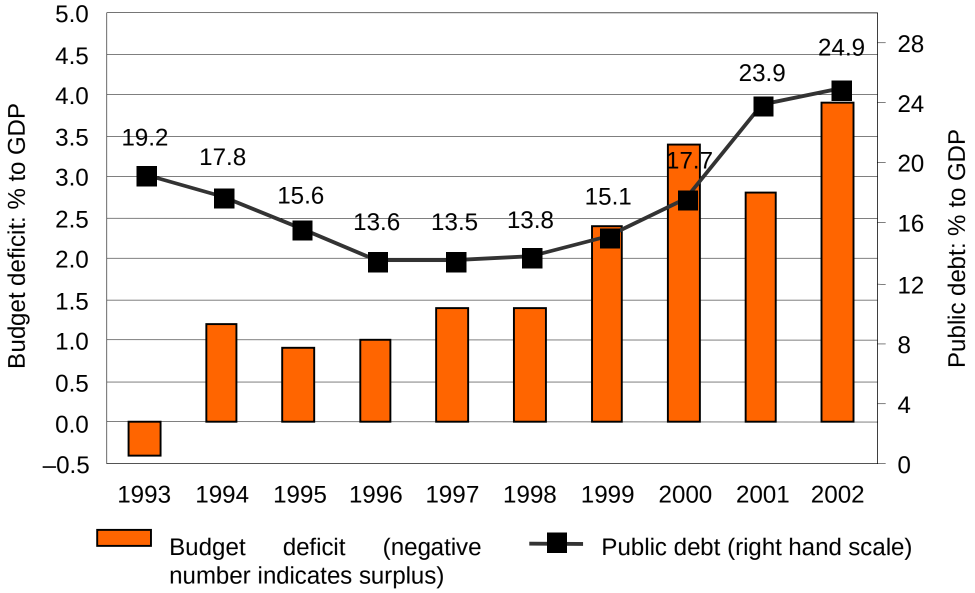
Graph 1

Fiscal developments since 1993



Source: Czech National Bank, based on the IMF's GFS approach.

The precise size of fiscal variables is uncertain in all transforming countries – and the Czech Republic is no exception. This is because large-scale one-off fiscal and quasi-fiscal operations were carried out in the 1990s that are not easy to classify. These include transfers of bad loans from the banking sector into a special government institution or state guarantees given to the banking sector to support bank loans to state companies. Classifications of such operations using different methodologies (GFS, ESA95) give different pictures of fiscal developments. Although these operations are precisely recorded in the cash-based accounting, the timing of their economic impact and hence their recording in the accrual accounting is uncertain. The openness and transparency concerning "hidden debts" – ie debts that were accumulated outside the government sector but have (or will have) a public character and will become part of the official public debt – can also significantly affect fiscal indicators.

3. Public finances during the economic transformation

Definition of the public sector and measurement approaches

The Czech Republic has a highly fragmented government sector. The basic structure of the public sector is similar to that in other countries, comprising central government, local governments, extra-budgetary funds and health insurance companies. But within the central government level there are large public institutions, such as the Czech Consolidation Agency and the National Fund, which complicate the analysis. There are a total of nine extra-budgetary funds with separate management, two of which are privatisation funds and seven are special purpose investment vehicles (eg for investments in transport infrastructure, housing and environment projects). They were established to exclude some projects from the annual planning horizon and political pressures that apply to the state budget and so allow a longer time horizon for their investments and planning.

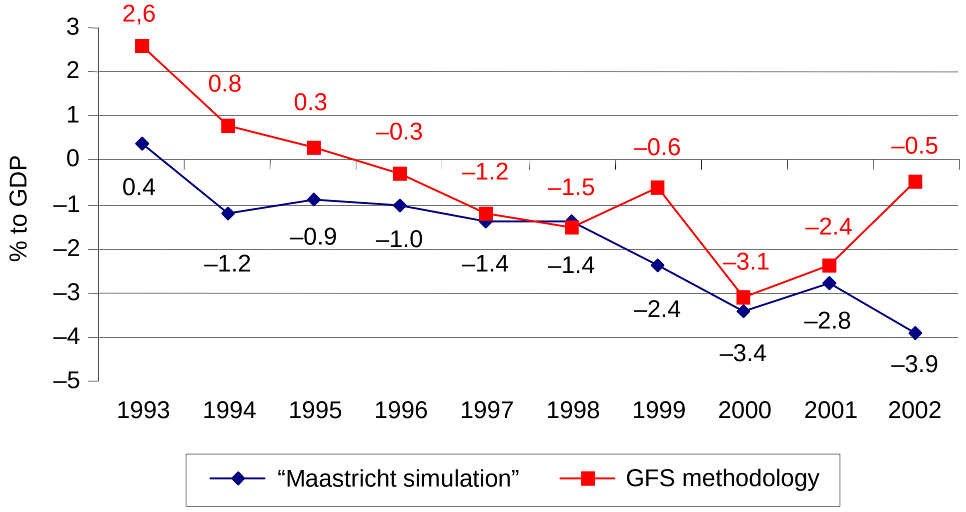
Public finances should be evaluated in a wider context of the impact of fiscal variables. Accordingly, public finance analyses should take account of all levels of government: the state budget, the extra-budgetary funds, possible quasi-fiscal activities of the central bank or other financial and non-financial institutions, the state's assets, expected government revenues, and the direct and indirect liabilities of the government. It is necessary to investigate the starting position of public finances; their sensitivity to short-run shocks (from macroeconomic conditions or the realisation of guarantees); the medium-run sustainability of expenditures and state debt; and the legal and organisational issues relating to the management of the public finances.

The "cash" approach previously used to monitor public finances has been replaced by the more systematic GFS methodology of the International Monetary Fund. Given the large volume of extraordinary transactions on both revenue and expenditure sides (eg sales of state property, coverage of losses in the banking sector) and the absence of prompt data about the budget balance derived from the national accounts, it was necessary to adopt a surrogate method closer to the ESA95 approach used in the EU countries. This method (sometimes called a "Maastricht simulation", as it gives an approximation of the deficit referred to in the Treaty) involves taking the available GFS cash deficit and projecting the extraordinary transactions such as privatisation revenues and government transfers to transformation institutions to cover their accumulated debts.

Graph 2 shows the differences in the general government balances reported using these two methods. The deficit in 2002 is larger according to the Maastricht simulation than the GFS methodology because of the inclusion of extraordinary privatisation revenues. As the amount of state-owned property declines, the government's privatisation revenues are dwindling. As a result, the favourable impression of the budget balance given by the GFS methodology could be misleading as, unless there are substantial cuts in government expenditures, the balance is very likely to deteriorate soon.

Graph 2

Public sector balance



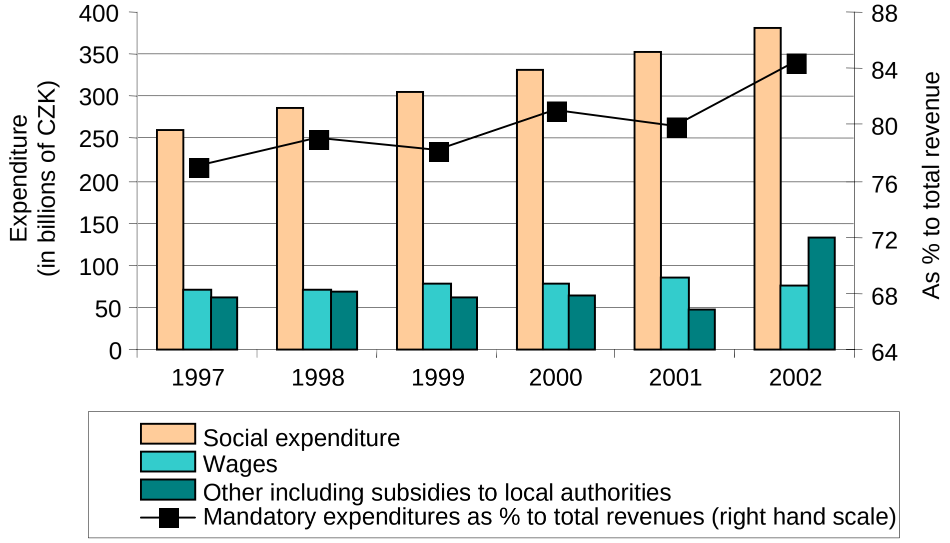
Sources: Czech National Bank; Czech Ministry of Finance.

Developments in the public sector since 1997

As Graph 1 shows, since 1997 public finances have been characterised by persistent deficits and a steadily rising public debt. The state budget deficit itself is the main cause of this deterioration, but the extra-budgetary funds are a potential danger, as they are highly dependent on privatisation revenues and the stock of state property is shrinking. One major reason for the growing deficits is the predetermined structure of state budget expenditures. The mandatory and quasi-mandatory expenditures – ie the legally required expenditures that cannot be changed in the short run at the government's discretion – are a rising proportion of the total (Graph 3).

Graph 3

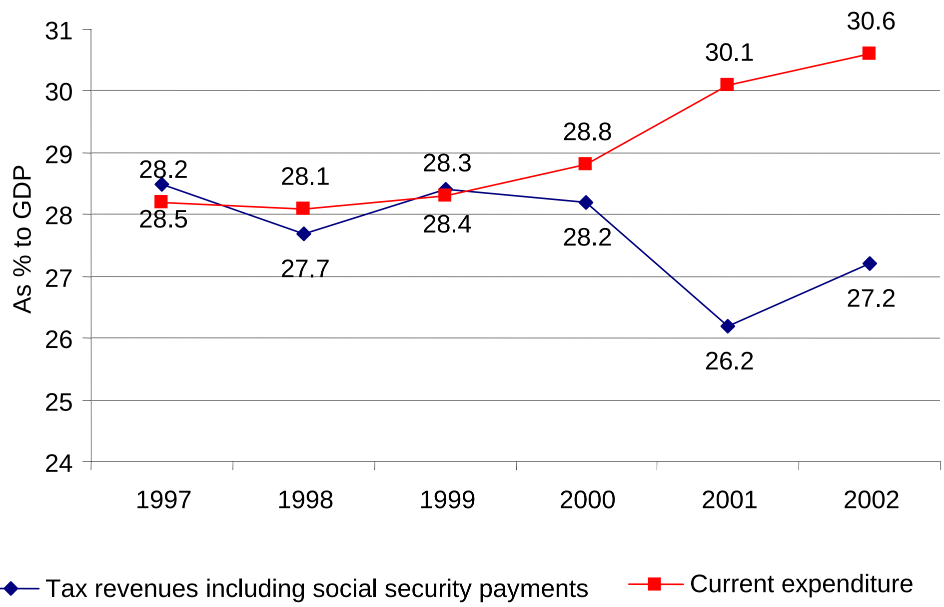
Mandatory expenditures



Sources: Czech National Bank; Czech Ministry of Finance.

Graph 4

State budget



Sources: Czech National Bank; Czech Ministry of Finance.

The bulk of mandatory expenditure consists of social expenditures – pensions, unemployment benefits and various other kinds of social benefits.

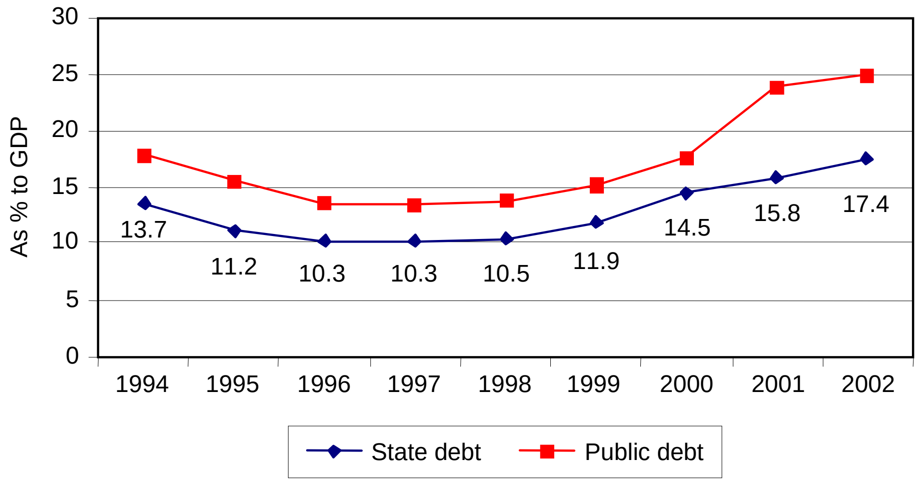
Another cause of the public finance deficits (according to the Maastricht simulation approach) is substantial use of extraordinary privatisation revenues in building infrastructure and housing. A significant volume of these investments are financed from privatisation revenues which will not be available in the future. Their extraction from the GFS deficit gives a better picture about the current state of the government finances in the Czech Republic.

The public debt is an important indicator of trends in public finance. The Czech Republic has for many years had a relatively low public debt. But since 1998 debt has been rising steadily (Graph 5), reflecting the public budget deficits and the “transformation losses”.

The dynamics of the public debt depends on the speed of exposure of the “hidden debts” created during the transformation process and accumulated in special institutions (such as the Czech Consolidation Agency). The hidden debts are around 10% of GDP, so their inclusion would increase the public debt/GDP ratio to at least 35%; see Polackova-Brixi (2000) or Bezdek and Krejdl (2003).

Graph 5

Public/state debt



Sources: Czech National Bank; Czech Ministry of Finance.

4. New procedures for fiscal analysis

During the early years of economic transformation, the public finances have been subject to standard macroeconomic analysis. But given the relatively balanced state budget and initially low public debt, fiscal policy did not attract rigorous attention. This attitude changed substantially in the late 1990s, when the government deficit and public debt began to rise. Fiscal policy, which started to lose its stabilising function and was rather procyclical in certain periods, began to play a more significant role in economic development. The Czech Republic’s integration into the EU structures also increased demand for better fiscal data – for instance the SNA data on the government sector.

Fiscal analysis in the Czech Republic is primarily focused on key areas such as the public budgets, the fiscal stance, the fiscal impulse, the functioning of automatic fiscal stabilisers, and public debt. Relatively less attention is currently devoted to assessing long-term sustainability and the impact of the ageing population.

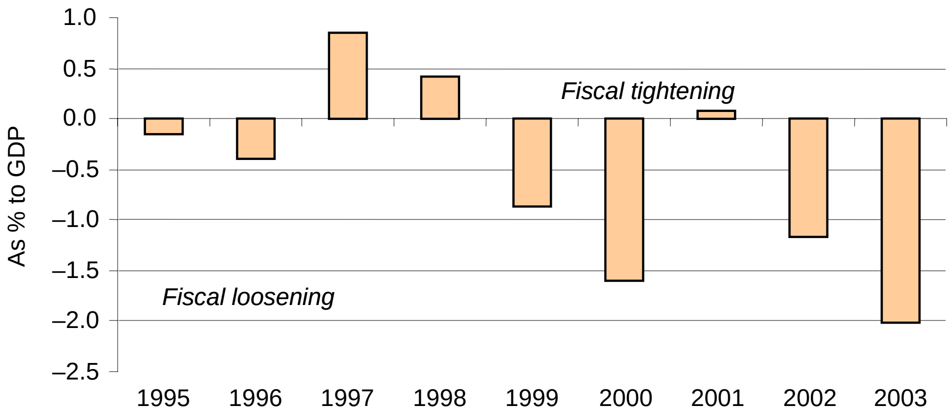
The budgets at all levels of the government sector are monitored in fair detail by the Czech National Bank (CNB). A major challenge is to speed up the transition to the standard SNA/ESA95 methodology. This is primarily a task of the Czech Statistical Office. However, the transition to and implementation of the ESA95 standards (such as accrual accounting) looks to be a long-term affair. The principles of accrual accounting are fully applied only in a small part of the public budgets (eg the National Property Fund and some of the smaller extra-budgetary state funds). Although preliminary ESA95 data are available, they may be subject to revisions. The more accurate results are due later in 2003. A principal obstacle to using this information for economic policy is the long time lags. Improving the quality and shortening these lags would be more than welcome.[2]

At the end of the 1990s, the CNB became one of the first institutions in the Czech Republic that started analysing the cyclically adjusted public budget balance. This procedure, common in other European countries, provides better information about the economic behaviour of the budget balance and its interaction with the business cycle than the unadjusted budget balance. These analyses allow calculation of the "fiscal stance". In the Czech Republic, we mean by this term simply the annual change in the cyclically adjusted public budget balance (Graph 6).

Graph 6

Fiscal stance from 1995 to 2003

Annual change of cyclically adjusted primary budget balance



Source: Czech National Bank.

The adjustment method stems from the original OECD methodology (see eg Giorno et al (1995)). Rather than estimating potential output through a Hodrick-Prescott filter or Cobb-Douglas production function, information about the output gap generated by the CNB's macroeconomic model is employed. The majority of tax components display a certain degree of sensitivity to the business cycle, whereas on the expenditure side probably only the unemployment expenditures do so, but the correlation is not very strong.

For achieving optimal monetary and fiscal policy coordination, the relevant analytical issues include not only assessing the fiscal stance per se, but in particular evaluating the way in which the fiscal stance feeds through into macroeconomic developments. Above all, this involves evaluating the effects of government economic policy on the individual components of domestic demand, on output and subsequently also on inflation. Accordingly, increased attention is being devoted to analysis of the fiscal impulse. However, it should be said that analysis in this area at the CNB is just beginning.

The CNB uses a macroeconomic model to forecast inflation. This model, however, does not have a full fiscal block. This means that there are obvious limitations in the evaluation of the fiscal influence on macroeconomic developments. In response, in 2001 an analytical framework was designed which endeavours to estimate the effect of the budget deficits on each demand component. Owing to a number of limitations in applying this analytical framework, the management of the CNB has approved

2 The Czech Statistical Office currently produces the definite or semi-definite figures based on the ESA95 methodology with a time lag of approximately two years. Previous ESA95 data are only estimates by the Ministry of Finance.

a long-term research project to develop a model of the fiscal impulse. The NiGEM and QUEST models are currently being studied to see whether they meet the needs of this project.

Given the Czech Republic's integration into the European Union and EMU, the functioning of automatic fiscal stabilisers is also becoming a subject of analytical interest. The operation of such stabilisers would help the Czech Republic to fulfil the basic principles of the Stability and Growth Pact. Previous research in this area has focused primarily on measuring the partial elasticities of selected revenue and expenditure items with respect to fundamental macroeconomic variables. Certain linkages have been identified, for instance, between VAT collections and GDP and between personal income tax and GDP. Work on establishing a special analytical apparatus is currently in progress.

The rising level of public debt in the Czech Republic is heightening the importance of analysing the effect of the debt financing structure on certain macroeconomic variables. First and foremost is the "crowding out" effect, ie the impact of domestic public debt financing on interest rates and the availability of credit to the private sector. The analyses conducted so far suggest that the budget deficit is currently being financed with no apparent implications for interest rates and private sector financing. Another important area of analytical interest is a linkage between the exchange rate and external debt financing. Because of the Czech koruna's appreciation against the euro during 2002, the CNB and the Czech government concluded an agreement which, among other things, limits the use of bond issues on foreign markets for covering the budget deficit.

5. European integration and Czech fiscal policy

Numerous issues have been, and are being, dealt with in connection with the Czech Republic's entry into the European Union and later to EMU. The first group of issues comprises institutional measures such as fiscal decentralisation. New self-governing regions have been established and new budget rules have been issued for both central and local governments. Moreover, a large part of the legal system has been harmonised with EU requirements. This process is almost complete and in this regard we could say that the Czech Republic is ready to join the European Union.

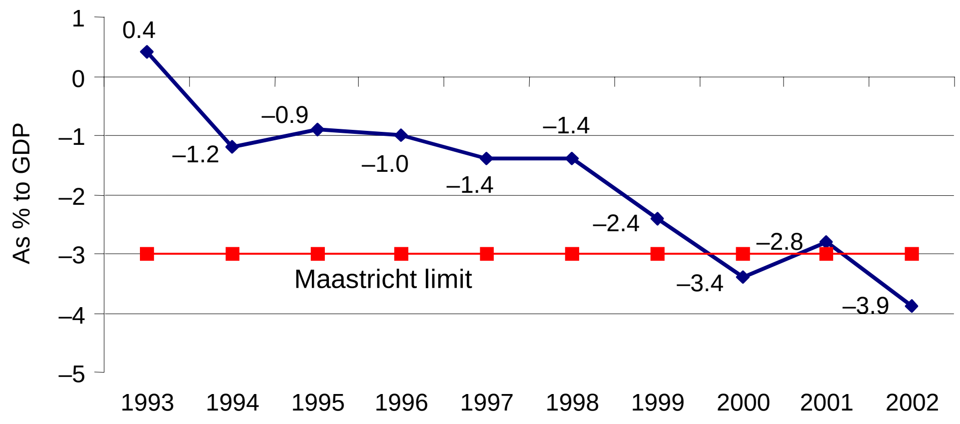
The second group of issues comprises the development of public finances and the need for consolidation to fulfil the Maastricht criteria. The budget deficit has exceeded the required 3% of GDP since 2000 (Graph 7) and is expected to exceed 6% in 2003. This is mainly due to structural problems, which are above all concentrated on the expenditure side of the budget and extra-budgetary funds. Fiscal policy is becoming one of the key medium-term risks to the Czech economy, as it is exhibiting a strong tendency towards procyclical behaviour. There are not sufficient instruments built into the system for addressing this problem at the moment, but the government is considering certain remedies as a part of the fiscal reform effort.

The need for fiscal consolidation is thus becoming a pressing issue. This consolidation should take the form of a mix of both revenue and expenditure measures, emphasising reform of the mandatory expenditures. Short-term measures to limit particular expenditures should be accompanied by long-term reforms, for example in the area of the pension system. Given the modest decline in the total tax burden, there might also be some space for measures on the revenue side. Although the real public finance consolidation process has not moved forward very much in the Czech Republic, the government's official obligation to fulfil all the conditions of EU accession provides a guarantee that this issue will be resolved in due course.

The Czech Republic's public debt is still well below the Maastricht limit of 60% of GDP (Graph 8) because of the favourable position of the public finances at the start of the economic transformation. However, since 1998 the public debt has doubled, and further growth can be expected unless the structural public finance problems are resolved. Although there is little danger that the Czech Republic's public debt will surpass the 60% limit in the next few years, it is still possible that it could exceed 40% of GDP once all the transformation losses have been covered. In this connection, there are pressing questions regarding the financing of the debt and related macroeconomic aspects regarding the development of interest rates and the exchange rate. A sharp rise in public debt caused by large consecutive public budget deficits (of around 7% of GDP) could ultimately lead to macroeconomic imbalances.

Graph 7

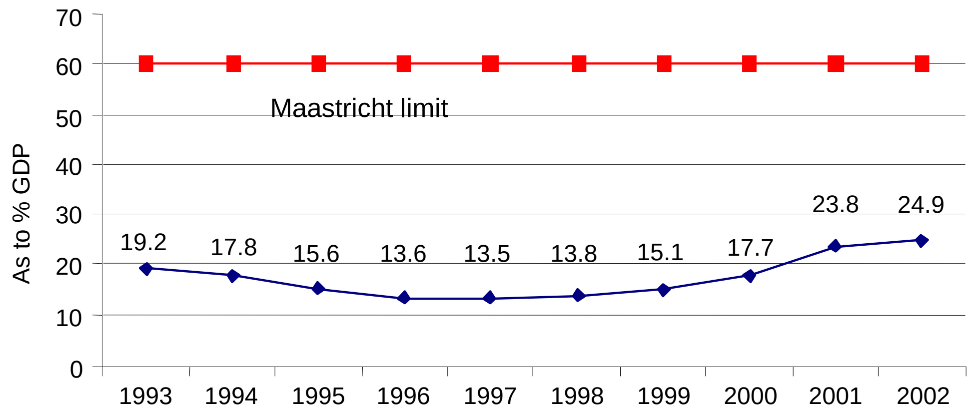
Public sector balance and the Maastricht criteria



Source: Czech National Bank.

Graph 8

Public debt and the Maastricht criteria



Source: Czech National Bank.

6. Conclusion

The Czech Republic's public finances have been characterised by persistent growth in the deficit and public debt. This reflects both "transformation losses" and structural problems built into the Czech public finances. The structural problems are concentrated both on the expenditure side of the state budget and in a number of extra-budgetary state funds. Mandatory state budget expenditures make up around 85% of all state expenditure. This severely limits the government's ability to implement discretionary fiscal policy. Fiscal policy in the Czech Republic is continuing to lose its stabilisation function and in the last few years has not been entirely in conformity with the principles applied in the European Union. The government has already recognised this problem and is trying to implement a fiscal reform that could solve some of the pressing fiscal issues.

Regarding the CNB's monetary policy, public finances are treated as one of the key medium-term macroeconomic risks. Given the current situation, with low GDP growth, the potential adverse implications of excessive government sector deficits are clearly visible. If the current trends in fiscal policy continue, this may give rise to serious macroeconomic imbalances, and to external imbalances in particular. Going forward, the considerable uncertainties regarding Czech public finances are therefore complicating the central bank's monetary policy-making, especially with respect to the need to set an optimal monetary policy mix.

Consolidation of Czech public finances is a current macroeconomic necessity not only with regard to the Czech Republic's EU integration efforts, but also for strong and sustainable macroeconomic development in the medium and long run. A stabilising reform of public finances has yet to be approved in the parliament, but given the government's explicit obligation to fulfil all the conditions of the Czech Republic's accession to the European Union and later on EMU, this objective should be fulfilled.

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