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# DEALING WITH THE STATE BUDGET: AN ECONOMIC APPROACH

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This year the public budgets deficit will be CZK 208.8 billion, or 5.7% of GDP<sup>i</sup>, and public debt will grow to 38.4% of GDP. The central government's budget deficit (CZK 166.7 billion, or 4.5% of GDP) plays a dominant role in the total deficit as well as in the debt growth. Fighting the deficits is one of the new government's main priorities. Several risks stand in the way to its permanent reduction:

- The risk that the impetus for expenditure reductions will evaporate quickly. Experience from countries such as Sweden and the Netherlands shows that for a lasting deficit reduction it is necessary to have a long-term and maximally binding strategy.
- The risk that the expenditure reductions in coming years will be based on across-the-board cuts or will be targeted randomly, driven by an effort to cut costs quickly in a politically acceptable way, with no regard to priorities and without evaluating the benefits of individual programs. Rather than further cuts, the Czech Republic needs to restructure its expenditures and use them more efficiently.<sup>ii</sup>
- The risk that reducing expenditures or reducing taxes will not be accompanied by deeper reforms that would render expenditures and

taxes more efficient and would contribute to lower deficits and to a better functioning of the economy.

Experience from various countries and modern economic theory suggest answers to the following questions: How should fighting the deficit play out in the prepared 2011 budget and in further steps to reform public finances? How to reduce the deficit efficiently and sustainably? What should be the government's budget priorities?

## **1. Committing to a long-term deficit-reduction plan.**

Have a budget strategy and corresponding goals in expenditures and taxes for the entire electoral period. The goals must be concrete, clearly formulated and credible. They should at least contain stabilizing the debt at 50% of GDP.

*The Government's Policy Statement's short-term goal (public budget deficits not exceeding 3% until 2013) is a step in the right direction; the mid-term goal (that by 2016 the state should not have to borrow to finance its regular operations) is very general and essentially allows for unlimited total deficits.*

*The state budget draft expects a total deficit of 3.7% of GDP and a primary deficit of 1.8% of GDP. If the growth of Czech economy corresponded to the current macroeconomic predictions of IDEA-CERGE-EI<sup>iii</sup> (and returned to historical averages after 2015)*

and if primary deficits were kept below 1.8%, the growth of the debt should slow down significantly after 2014 and de facto become stabilized at 44-48% of GDP<sup>iv</sup>. Since 2013-2015, regular deficits should also fulfill the Maastricht criteria limits.

## **2. Following and actively using expenditure frameworks.**

Expenditure frameworks are legally binding limits on the growth of the state budget's expenditure in future years, approved by the Chamber of Deputies. As much as the 2011 budget appears to be an immediate priority, it will be approved together with the expenditure frameworks for 2012 and 2013. In many ways these frameworks will be more important than the budget itself, since they will determine future expenditures.

*The government should not only follow the frameworks (which it did not always do in the past), but also to use them as a tool for pushing through a deficit reduction strategy. The current budget draft fulfills the first recommendation, but only partially the second one – the frameworks for 2012 and 2013 expect 2.1% yearly growth in nominal expenditure, slightly above the expected inflation. That means a preservation, not a reduction, of the government's real expenditures. With the exception of 2011, the deficit reduction strategy does not draw on real savings in expenditures, but instead relies on economic growth, thanks to which revenues automatically grow faster than expenditures. The frameworks will hence fulfill their role only under optimistic macro-economic development.*

## **3. Reforming fiscal institutions.**

Fiscal institutions are rules and procedures governing the drafting and legislative approval of the budget. Well-designed fiscal institutions help decrease deficits and allocate government expenditures more efficiently – for instance the successful budget reforms in the Netherlands or Sweden relied on a reform of institutions. Economics offers several recommendations for optimal fiscal institutions in the Czech Republic: Procedural rules and transparency are more efficient than legally binding balanced budgets and similar rules.<sup>v</sup> For fiscal institutions to have a positive effect on budgets, they must be enforceable by an entity independent from the Chamber of Deputies.<sup>vi</sup> Changing the rules must be far more difficult than changing the budget itself.

*For instance, instead of gradually updating expenditure frameworks, total expenditures for the entire electoral period should be approved and only small deviations could be approved in the following years under certain conditions.<sup>vii</sup> The Senate's approval should also be necessary to approve legislation about budget rules (as it is already the case of the electoral law).*

## **4. Consistently abolishing and limiting tax exemptions and not creating new ones.**

Tax exemptions not only directly decrease tax revenues but also indirectly induce greater consumption of favored goods, greater tax evasion, more aggressive tax optimization, and force the state to set higher tax rates. Just in the case of the income tax the direct effect of tax exemptions decreases budget revenues by 18 percent of the planned deficit.<sup>viii</sup> Besides this amount, reducing tax exemption would further decrease the deficit by 0.9 percent<sup>ix</sup> through indirect effects and would do away with deadweight costs on the order of CZK 1 – 2 billion arising from these exemptions.<sup>x</sup>

*There are few economically justifiable exemptions. Mortgage interest deductions, meal vouchers, recently established value-added tax deductions from cars, or the currently considered road tax exemptions are not justifiable. Exemptions that might possibly be preserved should target solely the poor taxpayers. For instance if it is a political decision to help people acquire housing by deducing interest from mortgages, then let the deduction be limited to loans taken by people with lower incomes.<sup>xi</sup>*

## **5. Making the tax system systematically more efficient by converging tax rates.**

The Czech Republic does not have an efficient tax system. Inefficiency does not lie merely in administrative costs for taxpayers and the state. Great differences between tax rates directly prompt shifting of incomes and profits to categories with lower tax rates.<sup>xii</sup> The price is paid by those without the ability to perform such tricks – ordinary citizens.

*Labor incomes of a regular household with children incur a 54% marginal tax rate – more than in social-welfare states like Denmark or Sweden, let alone the post-communist countries.<sup>xiii</sup> Budget-neutral reduction of the payroll tax combined with converging value-added tax rates are a priority that should be carried out completely independently of the pension reform. This will also enable the converging of the payroll tax bases of small entrepreneurs and employees without having to directly raise tax rates for small entrepreneurs. In an effort to help the poor, some taxes and welfare payments duplicate each other (for instance tax bonuses and child benefits) and create poverty traps (100% tax rates) even for households where the main provider earns 60-80% of the average wage.<sup>xiv</sup>*

## **6. Fighting corruption and making public procurement transparent.**

Even a very conservative estimate of public procurement overpricing resulting from non-transparent and inefficient selection processes accounts for 24% of the

planned deficit.<sup>xv</sup> Making all the information about state expenditures and public procurement (submitted offers, justification of a selection, content of contracts, etc.) publically available, increased focus on corruption, and more efficient punishments are a way to decrease this amount.

*The number of people sentenced for transgressions in public tenders and public auctions (4) or accepting bribes (51) make a mockery of the public's perception of corruption and the discoveries of investigative journalists about corruption in public procurement.<sup>xvi</sup> Long jail terms (which merely amount to populist declaration because courts refuse to use them and substitute them with short probation sentences) are not efficient punishments – those would especially be direct pecuniary fines or shorter unconditional sentences that would actually be imposed.*

### **7. No across-the-board expenditure cutting, rather getting rid of needless outlays.**

Some programs do not create value that would justify their generous state financing. Some might be under-financed and it makes no sense to reduce them by across-the-board cuts. A rational approach requires systematic evaluation of the real benefits of individual programs and their cancellation based on collected evidence.

*Building savings is a perfect example of a program which, for CZK 13 billion a year (10% of the deficit), brings few positive and many debatable effects. At most 29% of this amount goes to households who thanks to building savings subsidies really save more; 30% of the poorest households receive only 9% of the total support; consequently building savings further deepens income inequalities.<sup>xvii</sup>*

### **8. While enacting today's cuts, thinking about optimal future strategies.**

Current expenditures cuts should target areas with expected long-term decline in funding.

*For instance if a ministry must cut money spent on salaries and at the same time the government's policy statement expects a shift in the financing of cities and municipalities from in-kind grants to self-financing, it is more than logical to already cut expenses on salaries in departments that redistribute funds to municipalities.*

It is also necessary to keep in mind the political acceptability of cuts in future years and push for them already at the present moment in one legislative act.

*For instance the intention to decrease the subsidies for building savings on a one-time basis now and a little bit more in the future is praiseworthy. But will there be willingness to approve further cuts in subsidies in two years down the road? It is more appropriate (and politically more feasible) to enact a long-term plan for decreasing support already at this moment.*

### **9. Substituting public expenditures with intelligent reforms.**

In recent years, the principle that the lack of anything can be solved with a grant from public funds has taken root. It is often a better solution to eliminate the structural cause of the problem.

*For instance, the government spends CZK 5.3 billion a year to subsidize voluntary (3<sup>rd</sup> pillar) pensions insurance. But average deposits into pension funds represent 2 percent of salaries which is not enough for ensuring "retirement with dignity." The real problem are low returns of the funds, resulting from over-regulated investment strategies and especially from extremely high marketing and administration costs, which cut at least 1.3 percentage points from the returns.<sup>xviii</sup> Yet costs realistically should not exceed 0.4 percentage points.<sup>xix</sup> Systemic reform of the pensions funds market – even if it managed to increase net returns by a mere half-percent – would allow for the average government contribution to decrease by CZK 56 (and thereby decreasing the deficit by more than 2%<sup>xx</sup>), while retaining the same amount of end-savings with the same deposits of a "typical" saver.<sup>xxi</sup>*

### **10. Emphasizing rational investment into infrastructure.**

In all countries, high-quality infrastructure has strong direct and indirect positive impacts on the economy. In a small country like the Czech Republic this positive impact can be stronger than in many other countries, especially for creating a unified and flexible labor market and consequently also decreasing overall unemployment and boosting labor productivity. <sup>xxii</sup> Infrastructure development does not necessarily require increased expenditures from the state's budget, but especially their efficient use and greater financial contributions from users themselves.

*To develop infrastructure first take advantage of a clampdown on corruption and greater efficiency in public procurement, greater use of tolls (also for passenger cars, and especially in cities) or more competition in public transport (eliminating all barriers to the entrance of private rail carriers).*

### **11. Not jeopardizing, and finishing the reform of tertiary education, science and research.**

For a country poor in raw materials, investment in high-quality human capital is strategically important both for boosting labor productivity and people's incomes, and for eliminating income inequalities; the relative shortage of educated people on the labor market causes that among OECD countries the Czech Republic has the second highest discrepancy in salaries between university-educated and high-school educated employees (average of 83%).<sup>xxiii</sup>

*In science and tertiary education, the state should concentrate its funds both on internationally recognized institutions and programs, and on improving the accessibility to high-quality bachelor's degrees to more people. Besides expanding accessibility, the budget argument speaks in favor of implementing tuition fees – it allows increasing the total resources for universities with lower expenses for the state's budget. The allocation of public funds in secondary education should more closely reflect the real demand for schools.<sup>xxiv</sup>*

## **12. Considering adopting the euro right away when the public budgets allow it.**

The government's program proclamation suggests public finances will be ready to join the eurozone in approximately 2013-14. Adopting the euro will also have (mostly positive) long-term budget effects.

*Adopting the euro will enable financing the government's debt with lower interest rates,<sup>xxv</sup> will decrease the real value of the debt thanks to the influence of the euro's adoption on domestic inflation through of the so-called Balassa-Samuelson effect<sup>xxvi</sup>, will save administrative costs of the public sector for currency conversions and other bank transactions and will decrease the uncertainty of public institutions over the real value of European grants.*

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<sup>i</sup> Public budgets deficit in GPS 2001 methodology. Budget deficits, adjusted for the influence of funds from transformation institutions and the influence of EU resources, will reach -4.9% of GDP. Source: Ministry of Finance of the CR

<sup>ii</sup> In 2010 as well, the ratio of public budgets in GDP dropped, by 0.1% of a percentage point. Source: Ministry of Finance.

<sup>iii</sup> [http://idea.cerge-ei.cz/documents/Makropredikce2010\\_05.pdf](http://idea.cerge-ei.cz/documents/Makropredikce2010_05.pdf).

<sup>iv</sup> The relatively high variance is due to the uncertainty about the future development of GDP, interest rates for the government debt, etc. Many variables (for instance future sensitivity of primary deficit to economic growth) are also very hard to estimate.

<sup>v</sup> For an overview of studies analyzing the efficiency of fiscal rules (legislative restrictions of debts, deficits and other parameters of public finances) and fiscal institutions (legal procedures for creating budgets), see for instance von Hagen, J: Fiscal Rules, Fiscal Institutions, and Fiscal Performance, Economic and Social Review, Vol. 33, No. 3, Winter, 2002.

<sup>vi</sup> An illustration to this is one of the conclusion of the study Bohn H. a R. Inman: Balanced-Budget Rules and Public Deficits: Evidence from the U.S. States, Carnegie-Rochester Conference Series on Public Policy, Vol. 45, 1996. Fiscal rules limiting budget deficits of the U.S. states have a greater impact on real deficits in states where supreme courts are independent on the legislative and executive branches. In the Czech environment, this begs the question whether the Supreme Court should have an explicitly designated authority to determine whether the procedure for the approval of and the content of a budget corresponds with legal rules.

<sup>vii</sup> This proposal is spelled out in detail in Švejnar J., L. Dušek a V. Semerák: "An Intelligent Reform of Public Finance," Institute for Democracy and Economic Analysis – Economics Institute of the Academy of Sciences of the Czech Republic, May 2010, pp 15-18.

<sup>viii</sup> That is, CZK 24 billion. Source: The Ministry of Finance of the CR "An Overview of Tax Exemptions," available at [http://www.mfcr.cz/cps/rde/xchg/mfcr/xsl/ek\\_rvf\\_kompletni\\_material.htm](http://www.mfcr.cz/cps/rde/xchg/mfcr/xsl/ek_rvf_kompletni_material.htm)

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<sup>ml</sup> The amount of 24 billion represents only the part of the exemption that the Ministry of Finance recommended to eliminate.

<sup>ix</sup> That is, CZK 1.2 billion.

<sup>x</sup> A simple estimate of the indirect effects on the deadweight costs use formulas for calculating the changes in tax revenues and deadweight costs as a function of the elasticity of taxable income and the ratio between the actual and potential tax base. (See Feldstein, M.: Tax Avoidance and the Deadweight Loss of the Income Tax, Review of Economics and Statistics, Vol 81 (4), 1999: 674-680; Kopczuk, W.: Tax Bases, Tax Rates, and the Elasticity of Reported Income, Journal of Public Economics, Volume 89 (11-12), 2005, 2093-2119.) The calculation is available upon request.

<sup>xi</sup> We recommend capping the mortgage interest deduction at the 3rd decile of newly awarded mortgages for purchasing housing. According to the data of the Ministry for Regional Development, in 2008 the average mortgage amounted to CZK 1.7 million. A detailed distribution is not listed, but the 3rd decile is inevitably significantly lower than CZK 1.7 million. (Ministry for Regional Development, Mortgages 2002-2010, available at [http://www.mmr.cz/Bytova-politika/Statistiky-Analyzy/Statistiky-z-oblasti-bytove-politiky-\(1\)/Hypotecni-uvery/Hypotecni-uvery-\(2002-2008\)](http://www.mmr.cz/Bytova-politika/Statistiky-Analyzy/Statistiky-z-oblasti-bytove-politiky-(1)/Hypotecni-uvery/Hypotecni-uvery-(2002-2008))).

<sup>xii</sup> For instances using task-based labor contracts, or shifting companies' profits to the salaries of their owners-managers which are taxed with a 15% rate above the social and health insurance ceilings.

<sup>xiii</sup> Source: Taxing Wages 2008-2009, Table I.6., Figure I.6., OECD 2001:

<sup>xiv</sup> Jan Pavel: The impact of the changes in the benefits and tax systems in 2004-2009 on the motivation to work indicators in the CR. A study, the Ministry of Finance of the CR 2010.

<sup>xv</sup> That is, CZK 32 billion. Source: Transparency International: "An Estimate of the Inefficiency of Public Spending in Public Procurement in the Czech Republic," Transparency International 2007, [http://www.transparency.cz/pdf/publikace/vz\\_odhad\\_neefektivita.pdf](http://www.transparency.cz/pdf/publikace/vz_odhad_neefektivita.pdf)

<sup>xvi</sup> Statistická ročenka kriminality 2008 (Statistical Yearbook of Crime), Ministry of Justice of the Czech Republic

<sup>xvii</sup> Švejnar J., L. Dušek a V. Semerák: "An Intelligent Reform of Public Finances", Institute for Democracy and Economic Analysis – Economics Institute of the Academy of Sciences of the Czech Republic, May 2010, pp. 20-22, 35-36.

<sup>xviii</sup> "Pensions Insurance with Government Subsidy, 1995-2009", Association of Pensions Funds of the CR, April 2009.

<sup>xix</sup> According to the experience of private index funds (Fidelity and Vanguard), the Norwegian State Pensions Fund (Statens Pensjonsfond), consultations with the leaders of domestic investment companies.

<sup>xx</sup> That is CZK 2.8 billion.

<sup>xxi</sup> Decreasing the contribution by 56 makes equal the total amount of savings at the age of 65 for the typical participant in pensions insurance with the current average state contribution (CZK 105 a month) and funds revenues at the level of average revenue in 2000-2009 (3.137 percent), and the total amount of savings of the same typical participant with the decreased contribution of CZK 49 and the revenues increased by 0.5 percentage points. Details of the calculation are available upon request.

<sup>xxii</sup> Thanks to easier commuting from regions with higher structural unemployment to regions with richer work opportunities. For instance the effect of the Plzeň-Praha highway, when Plzeň has become a "suburb of Prague," according to international criteria for commuting.

<sup>xxiii</sup> Education at Glance 2010, Table A.7.1. OECD Indicators, OECD 2010.

<sup>xxiv</sup> Knot O. a D. Munich: High School Admission Procedure in the Czech Republic: Example of Inefficient Matching Mechanism, forthcoming as a CERGE-EI Working paper 2010, simulate of alternative procedures for

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admitting students to schools and shows that in the current Czech system the real demand for secondary schools – especially academic high schools (gymnasia) – is significantly higher than could be inferred from the number of applications.

<sup>xxv</sup> Although on the theoretical level the effect of monetary integration is ambiguous, empirical analyses (see for instance Bernoth, von Hagen, Schuknecht: Sovereign Risk Premiums in the European Government Bond Markets, GESY discussion paper, 1512006) show the existence of a small – though not always statistically important – positive effect of EMU on financing the government's debt.

<sup>xxvi</sup> Empirical analyses point to an insignificant (Egert et al.: The Balassa-Samuelson Effect in Central and Eastern Europe: Myth or Reality? *Journal of Comparative Economics* Vol 31, Issue 3, September 2003) or relatively small (Sinn a Reutter, The Minimum Inflation Rate for Euroland. NBER working paper 8085, January 2001) influence of the Balassa-Samuelson effect on the inflation differential between the Czech Republic and Germany. Additionally, the growth of salaries – related to this effect – was necessarily more than compensated by the growth in productivity (if the economy does not face other structural problems).

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