

## The Parties Unified for the Public Sector

For the last eighteen months, **businesses** and **individuals** have sweated while the government debated, rejected and otherwise delayed any measures that might have helped the private sector withstand the financial crisis. Despite the collapse in orders and the drastic cuts in the workforce, the political community seemed quite serene. When leading politicians announced that the country would be a prosperous island in the middle of meltdown, businesspeople closer to the action wondered whether they had descended into insanity.

The last week brought **good** and **bad news**. **The good news** is that the government- as well as the political parties twisting its arms behind its back- has finally acknowledged that the economic crisis is impacting the Czech Republic. **The bad news** is that the government seems concerned only with finding ways of minimizing its impact on the public sector. Their solution may make things worse for the private sector- and, as a consequence, for the government as well.

The government awoke to reality when 2009 tax **revenues dropped by 19%** year-on-year. On Friday, the haggling parties achieved a compromise on the **2010 budget**. After a long weekend, the government met Tuesday to confirm the details and to announce the numbers. Yet, there is no real news, and no real solution, in this budget. We will pay more so the government will spend more. Since the government has never been able to estimate revenue or control spending, the numbers announced Tuesday should be treated as a finger in the wind. Outside of parliament, this budget creates more questions than it answers. Let's ask and attempt to answer some of the more prominent.

## Will it boost the economy?

The only way to produce sustainable government finance is to create the conditions for economic growth. If the government is truly concerned with stable long-term government, they should not take short-term measures that might delay the return of economic expansion. Yet, the government readily admits that their measures will turn growth back into recession. The Finance Ministry was predicting **GDP growth of .3% in 2010**. Minister Janota announced that **the package will reduce that number by .6-.7%**, turning the economy shaky growth back into recession.

This should come as no surprise to anyone who has studied economic history. The past tells us that **raising taxes during a recession delays recovery and may deepen the crisis**. So why is this government and parliament adopting policies that take such a risk? To reduce the public deficit for one year.

## Will the 2010 budget restore financial stability?

The deal was good public relations and shaky economics. The purpose was to **reduce the deficit** to below the magical threshold of CZK 200 billion. As many economists have pointed out, CZK 200 billion is a lot, but so is the CZK 167 billion deficit finally passed by the government. For financial stability, the number is not as important as the formula for reaching it. The Czech formula appears to be broken, and this agreement puts even more stress on the point of fracture.

Since 1998, Czech policymakers have followed a simple equation in public finance. They kept an accumulating deficit- averaging **CZK 60 billion annually**- under control by covering spending increases with rising revenues from an expanding economy. During the period, **revenues increased 98%** while **expenditures rose by 91%**. Even with this excess in income, the combined deficit mounted to CZK 661 billion between 1998 and 2008. This number did not seem to concern politicians or the ministry of finance, because, they explained, the Czech Republic maintained relatively low debt levels as a percentage of the GDP.

This easy formula cracked wide open this year. In the first three quarters of 2009, the treasury collected **CZK 150 billion less** than for the same period in 2008- a drop

## Revenue Comparison, IIIQ, 2007-2009

	2009	Revenues	Expenditures	Surplus/ Deficit
Budget		1 114 000	1 152 100	-38 100
IIIQ actual		643 910	733 490	-89 580
% total		58%	64%	235%
IIIQ 2008		794 460	783 980	10 480
2009 results as % of 2008		81%	94%	
IIIQ 2007		748 520	712 210	36 310
2009 results as % of 2007		86%	103%	

## Deficit, Budget vs. Actual Comparison, 1998-2008

	Budget Deficit	Actual Deficit	Difference	change yoy	accuracy ratio
1998	0	-29 331	-29 331		
1999	-31 015	-29 634	1 381	1,01	0,96
2000	-35 180	-46 060	-10 880	1,55	1,31
2001	-48 980	-67 704	-18 724	1,47	1,38
2002	-46 223	-45 716	507	0,68	0,99
2003	-111 300	-109 053	2 247	2,39	0,98
2004	-114 970	-93 685	21 285	0,86	0,81
2005	-83 585	-56 338	27 247	0,60	0,67
2006	-83 710	-97 580	-13 870	1,73	1,17
2007	-91 300	-66 392	24 908	0,68	0,73
2008	-70 800	-20 003	50 797	0,30	0,28
total	-717 063	-661 496	201 177		
ann. avg.	-65 188	-60 136	18 289	1,13	0,93

## Revenues, Budget vs. Actual, 1998-2008

	Budgeted Revenues	Actual Revenues	Difference	change yoy	accuracy ratio
1998	536 635	537 410	775		1,06
1999	574 112	567 275	-6 837	1,05	0,99
2000	592 156	586 208	-5 948	1,06	1,01
2001	636 197	626 216	-9 981	1,10	1,01
2002	690 400	704 967	14 567	1,08	1,02
2003	684 062	699 665	15 603	1,08	1,02
2004	754 081	769 207	15 126	1,07	0,99
2005	824 831	866 460	41 629	1,07	1,02
2006	889 392	923 060	33 668	1,11	1,05
2007	949 477	1 025 883	76 406	1,07	1,05
2008	1 036 511	1 063 941	27 430	0,99	0,98
% incr.	193%	198%			
avg. diff.			22 543	1,07	0,03
2009	1 114 000	643910*		1,07	

## Expenditures, Budget vs. Actual, 1998-2008

	Budget Expenditures	Actual Expenditures	Difference	change yoy	accuracy ratio
1998	536 635	566 741	30 106		1,06
1999	605 127	596 909	-8 218	1,05	0,99
2000	627 336	632 268	4 932	1,06	1,01
2001	685 177	693 920	8 743	1,10	1,01
2002	736 623	750 683	14 060	1,08	1,02
2003	795 362	808 718	13 356	1,08	1,02
2004	869 051	862 892	-6 159	1,07	0,99
2005	908 416	922 798	14 382	1,07	1,02
2006	973 102	1 020 640	47 538	1,11	1,05
2007	1 040 777	1 092 275	51 498	1,07	1,05
2008	1 107 311	1 083 944	-23 367	0,99	0,98
% incr.	206%	191%			
avg. diff.			20 214	1,07	0,03
2009	1 152 100	733 490		1,04	

## Social, Income vs. Spending, 1998-2008

	Social Tax	Social Costs	Deficit	% Total Deficit	Exp/Rev ratio
1998	203 910	221 088	-17 178	59%	1,08
1999	210 888	237 109	-26 221	88%	1,12
2000	222 176	255 073	-32 897	71%	1,15
2001	242 320	273 301	-30 981	46%	1,13
2002	258 513	292 242	-33 729	74%	1,13
2003	272 366	305 030	-32 664	30%	1,12
2004	293 304	313 215	-19 911	21%	1,07
2005	311 183	325 998	-14 815	26%	1,05
2006	333 702	354 442	-20 740	21%	1,06
2007	367 142	386 375	-19 233	29%	1,05
2008	385 504	400 917	-15 413	77%	1,04
% incr.	193%	198%			
deficit			22 543		
avg.				49%	1,09

Source: Ministry of Finance

of 19%. In the past, the government ran healthy surpluses through the first nine months of the year. This year, the budget imploded and reached a deficit of **CZK 89 billion through September**. Since the government turned a September surplus into a substantial deficit in previous years, we can expect some deeply red numbers by December of this year.

That result explains the government's sudden acknowledgement that the economic crisis is real. Instead of changing the formula, however, the government is relying on it even more. They will squeeze the economy by raising taxes. And they will become yet another example of a government which "cuts" spending by actually increasing it. This raises serious concerns on both the revenue and the expenditure side of this year's budget.

## Budget Comparison, 2007-2010

	Budget Revenues	% change yoy	Budget Expenditures	% change yoy	Deficit
2007	949 477		1 040 777		-91 300
2008	1 036 511	109%	1 107 311	106%	-70 800
2009	1 114 000	107%	1 152 100	104%	-38 100
2010	1 022 000	92%	1 185 000	103%	-163 000

Source: Ministry of Finance

## Will increased taxes bridge the revenue gap?

The government believes the **extra taxes** will make up some of the shortfall. Economists raise their eyebrows. Governments depend on jobs, profits, and spending to generate revenue. Jobs are fewer. Profits are lower. As a consequence, spending has slumped. Many doubt whether the revenue exists- no matter what the rate of taxation- to close up the hole caused by economic contraction. Tax increases will likely shift revenue between categories- the higher social and income tax revenues from raising social caps will reduce the VAT revenue as those people cut spending to compensate- than raise it.

The government, however, is betting that the public has extra income to spare. The **2010 budget calls for revenue to be 92%** of the budgeted revenue for 2009. As stated earlier, the **actual 2009 revenue is running at 81% of what the government budgeted**. Higher taxes will not account for an 11% increase in revenue, if it accounts for any at all. The rest will have to be raised by economic growth. During the golden years of expansion, **revenues rose by an average of 7%**. In 2008, the increase dipped to 4%. The number will be negative in 2009. The prediction here is that the government has overestimated 2010 revenues, perhaps substantially. **Each 1% shortfall represents CZK 10 billion. The government missed the budget revenue by an average of 7% for the last decade.** Do the math.

The difference between budget and reality should come as no surprise. It is hard to measure future economic activity with any precision. It is also hard to gauge how businesses and individuals will pay their taxes. Evasion is a major problem here. With profits and income tighter than before and taxes increasing, one can assume that the black market will grow. This creates a major policy issue for the future: **how fair is it to depend on a smaller group of the population to pay higher taxes?**

## Will the government compensate for decreased revenues by less spending?

Over the past months, we have witnessed business and individuals react to less revenue **by cutting spending**. The government has chosen a different path. Spending in 2010 is scheduled to **increase by 3%**. It will likely increase by more.

Since 1998, the government has spent 3% more than it budgeted; this amounts to CZK 20 billion in overspending annually. In election years- which 2010 will be- the government has averaged CZK 30 billion more spending than is budgeted. There are some flashes of optimism: the government spent less than budget in 1999, 2004 and 2008. In fact, the government reduced actual spending from the previous year. The reduction, however, was only 1%.

If history is a good guide, we can expect expenditures to be anywhere **between 1-6%** more than the budget. Any 1% increase amounts to **CZK 10 billion**. With a technocratic government composed of long-term state employees, and political parties focused on winning elections, Mr. Janota will have a major challenge to keep expenditures within sight of the budget.

## Will we actually keep the deficit below CZK 200 billion?

The budget does not seem to reflect the rapid **deterioration in the economy** and **tax revenues**. The government historically has spent much more than budgeted. This evidence paints an ugly picture. For the past two weeks, the politicians have sweated and battled and threatened to resign over what the budget deficit should be, but the budget deficit is a shimmering oasis of a number, and has a plus or minus of tens of billions of crowns.

## Can the current model be fixed?

Even if we do keep to the announced deficit, **the 2010 budget is not a long-term fix**. It continues to rely on increased revenue to contain, but not control, the deficit. The economy is not likely to grow by 5% annually for the next 10 years. The tax increases are meant to be temporary (we will see about that). The spending remains out of control.

There is a truth that we must face: the government is outgrowing the country. While the Czech **GDP has increased by 85%** since 1998, **tax revenues have increased by 98%, and state expenditures have increased by 91%**. If this continues, financial instability will increase incrementally each year. The model has to change.

## What needs to be addressed for real reform?

The new model must move in an opposite direction than the 2010 budget. Revenues have not been the problem. Spending has. **To fix spending**, the government has to address two areas that combine for more than 50% of total expenditures: social payments and internal transfers within the government.

**Social program costs have increased by 81% since 1998, and now comprise 37% of the total budget. Transfers to other bodies-such as regions and municipalities- have grown more egregiously: they are now 2.5 times their 1998 levels and take up 25% of the budget.**

Those two areas are not the only budget chapters where spending has increased faster than revenue since 1998. Remuneration of state employees has doubled. Interest payments have increased 2.2 times. However, those two areas combined only comprise 14% of the overall budget. Temporarily reducing the salaries of constitutional employees by 4% is like battling the deficit wave with a plastic beach shovel. Unless something is done about social costs or state transfers, the country can not have budget stability.

**State transfers** have been increasing 22% annually over the last 11 years. In 2008, the government delivered **CZK 266 billion** to other state bodies. That comes to **CZK 26,401 per citizen**. How effectively has this money been spent? As taxpayers, we have no way of knowing, and we can hold no one accountable. The solution may be to devolve taxation authority to regional and local bodies, and to cut their connection to the state budget. This would also allow taxpayers to determine more directly whether benefits match costs: a comparison of a local municipal tax rate versus the services supplied would reveal which local authority worked most efficiently to improve the lives of their constituents.

We are able to make such a comparison with **social programs**. And the news is not good. The programs are running about 23 billion in the red every year. Over the past decade, the social shortfall has contributed 49% of the overall deficit. Since 2004, the situation has improved, but the reason for this- revenues that have outpaced rising costs- has probably been reversed due to higher unemployment.

**The long-term outlook for social programs is not rosy.** If nothing changes, the aging population could conceivably bankrupt the country in the next fifty years. The first step to addressing reforms seriously is to shift the cost of social programs entirely onto social taxes. That means increasing the social tax while lowering the personal and company tax the same amount. Doing so would make the burden of the country's social programs clear to the people who pay them, and force an honest debate about their value and effectiveness.

### Revenue Breakdown, 1998-2008

	Personal Income	Company Income	Property	Social Insurance	Excise	VAT	Capital Income	Received subsidies/grants	Other	Total Revenues
1998	36 279	51 105	6 250	203 910	67 801	119 358	211	8 555	43 941	537 410
1999	35 131	86 441	6 824	210 888	73 143	138 282	281	10 838	5 447	567 275
2000	34 732	52 275	5 974	222 176	70 879	145 908	366	11 410	42 488	586 208
2001	78 588	68 877	6 421	242 320	65 810	121 174	511	808	41 707	626 216
2002	82 110	76 913	7 858	258 513	68 607	118 380	1 445	27 591	63 550	704 967
2003	88 629	84 270	8 773	272 366	72 761	125 657	511	7 509	39 189	699 665
2004	95 209	85 499	10 379	293 304	82 795	140 383	951	18 791	41 896	769 207
2005	94 773	100 275	8 107	311 183	103 626	146 823	969	67 760	32 944	866 460
2006	91 591	95 470	8 516	333 702	112 561	153 516	2 338	92 340	33 026	923 060
2007	102 137	114 751	10 576	367 142	131 591	166 628	1 243	100 707	31 108	1 025 883
2008	94 957	127 174	10 410	385 504	125 538	177 816	1 171	105 720	35 651	1 063 941
% increase	262%	249%	167%	189%	185%	149%	555%	1236%	81%	
% total revenues 98	7%	10%	1%	38%	13%	22%	0%	2%	8%	
% total revenues 08	9%	12%	1%	36%	12%	17%	0%	10%	3%	

Source: Ministry of Finance

## What is preventing these changes?

Today's budget reform appears to be much ado about nothing. At best, it applies a very loose band-aid to a bleeding public sector while shifting the economy into neutral. At worst, it could infect both the economy and the public budget with something more serious. What is needed is real reform. Real reform, however, requires a real election.

Whatever his reasons, CSSD Chair Jiri Paroubek was right to oppose cuts to social programs. No party and certainly no technocratic government has the mandate to change government in the fundamental ways necessary to achieve long-term financial stability. Parties can only receive such a mandate if they campaign on specific platforms. They cannot get it with orange platitudes or solutions backed by an empty blue sky.

We now must accept that we do not have the political leadership that will prevent companies and individuals from getting further bruised by the crisis. We should expect more in the future. As citizens, we can begin the process of budgetary reform by asking our political parties four questions during the upcoming elections, and voting according to who answers best.

## Expenditure Breakdown, 1998-2008

	Remuneration	Interest and other financial costs	Subsidies to business/npos	Transfers to other government budgets	Social Payments	Capital Payments	Total
1998	47 370	19 755	49 287	107 552	221 088	50 537	566741
1999	52 391	17 524	33 618	123 895	237 109	59 031	596909
2000	52 377	19 870	37 551	128 866	255 073	60 903	632268
2001	60 229	19 307	58 545	138 429	273 301	49 559	693920
2002	64 896	21 400	75 476	145 010	292 242	49 733	750683
2003	78 793	22 657	58 454	187 819	305 030	56 943	808718
2004	80 426	28 545	55 905	211 655	313 215	66 712	862892
2005	86 373	26 176	30 617	250 876	325 998	78 999	922798
2006	89 410	33 707	31 625	272 875	354 442	105 299	1020640
2007	95 087	34 193	33 882	305 624	386 375	115 527	1092275
2008	97 576	44 768	38 517	266 659	400 917	105 034	1083944
% increase	206%	227%	78%	248%	181%	208%	
98 pie	8%	3%	9%	19%	39%	9%	
08 pie	9%	4%	4%	25%	37%	10%	

Source: Ministry of Finance

## What is preventing these changes?

Today's budget reform appears to be much ado about nothing. At best, it applies a very loose band-aid to a bleeding public sector while shifting the economy into neutral. At worst, it could infect both the economy and the public budget with something more serious. What is needed is real reform. Real reform, however, requires a real election.

Whatever his reasons, CSSD Chair Jiri Paroubek was right to oppose cuts to social programs. No party and certainly no technocratic government has the mandate to change government in the fundamental ways necessary to achieve long-term financial stability. Parties can only receive such a mandate if they campaign on specific platforms. They cannot get it with orange platitudes or solutions backed by an empty blue sky.

We now must accept that we do not have the political leadership that will prevent companies and individuals from getting further bruised by the crisis. We should expect more in the future. As citizens, we can begin the process of budgetary reform by asking our political parties four questions during the upcoming elections, and voting according to who answers best.

### Question One

How can economic policy, including tax policy, increase economic growth?

To be fair, no one can predict how an economy will perform in the most stable of times. Stability is a synonym for lower (or ignored) risk. The current crisis is risk realized. In such a situation, individuals respond in drastically different ways. The essential unpredictability of these responses shred the generalizations on which economic models are built. We cannot criticize the budgetbuilders for not hitting the budget numbers exactly on the mark. We can question, however, why parties have responded so forcefully to the gaping holes in public finance after they were so ambivalent about helping the private sector on which the public sector is built.

### Question Two

Should government spending grow more or less than the GDP?

State spending is growing faster than the economy. This is a fundamental source of instability not only for public finance, but also for the economic well-being of the country. Parties should clearly state whether they are willing to curb spending to levels that are below the rate of GDP growth.

### Question Three

How can social payments be balanced with social tax revenue?

Parties that wish to continue the current benefits should make explicit how they will pay for them. Parties that wish to change the current benefits should explain clearly which benefits will be modified. All parties should agree to fund social programs only through social tax revenues so that the real costs are transparent.

### Question Four

How will your party increase transparency and accountability in the state transfers, as well as other areas of the budget?

A good government should operate its services more efficiently- more value per crown spent- than other governments. The Czech government cannot measure how well it does its job, because revenues are not placed together with expenditures. In this respect, it is like a family which does its finances according to another family's bank account.

## Wrapping up

Each party should state how it will measure the efficient use of public money, and should propose how the system of taxing can be better aligned with spending.

These are not easy questions to answer. The country is fortunate to have an election period, because it allows these questions to be debated and for people to choose the leaders who best reflect their own opinions. The risk, however, is that the political debate has become a sterile mask to hide the machinations of an elite that spans across the political parties and is buried deep within the bureaucracy. This forces the people to choose between Dalik or Tvrdik, despite the fact that the two work together more often than they oppose one another.

Nothing much can be done now but work hard and demand answers from the people who want to be our leaders. The era of the parties unified for the public sector has begun, and, if the people do not demand their representatives back, e Source: Ministry of Finance ven elections may not end it.

Research and Analysis by AmCham CR