INTERNATIONAL MONETARY FUND

Czech Republic—November 2002 Staff Visit

Concluding Statement (Preliminary)—November 19, 2002

1. During our current visit to the Czech Republic, we held discussions with the authorities focusing on their medium-term fiscal plans and the implications of these plans for the timing of euro adoption.

2. **The discussions were held against the background of a gradually but steadily deteriorating fiscal position**. The general government deficit (excluding privatization receipts) has increased over the past 5 years to reach 9 percent of GDP in 2002. While part of the expansion has come from bank restructuring costs—a legacy of earlier excesses—even excluding these, the general government deficit has risen by 4 percentage points to 5.3 percent of GDP this year. Deficit increases occurred both in years of weak and of strong economic growth, and therefore cannot be explained away as a cyclical phenomenon. That the problem is of a structural nature can also be seen from the gradual upward creep of government expenditure. The expenditure drift is partly explained by high and rising mandatory and quasi-mandatory public spending. The phenomenon was described in the World Bank's 2001 Country Study, which also suggested specific measures to control increases in these forms of spending. However, during 1997-2002, expenditures in most other economic categories also rose. This occurred at a time when the general government sector was becoming increasingly fragmented, with the splintering-off from the state budget of the extrabudgetary funds for transport infrastructure and housing and the creation of new regional governments. There is broad acknowledgement that this fragmentation allowed spending pressures to be accommodated.

3. **Until now, little concrete action has been taken by the government or parliament to address the growing problems in public finances.** This is confirmed by the 2003 state budget which recently passed its first reading, which implies a record underlying general government deficit of 5.6 percent of GDP (excluding privatization receipts, transfers to transformation institutions, and the effects of the flood).[1] The continued postponement of fiscal adjustment by the Czech authorities has been noted by many observers, including the OECD and the European Commission. That little action has yet been taken may be due to the low funding costs facing the government. This could result from: (i) relatively low public debt (about 25 percent of GDP), which—in spite of growing deficits—has been held down

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[1] Including flood-related spending, the general government deficit consistent with the 2003 state budget is 6.3 percent of GDP, about the same as the general government deficit based on the ESA95 methodology used to assess compliance with the Maastricht fiscal deficit criterion.

by large privatization receipts; (ii) low inflation; and (iii) Czech banks' reluctance to extend credit to local companies, preferring instead to buy government paper. These have combined to keep down government interest expenditures and enabled it to extend the average maturity of its debt. However, in the future, some of these factors, and their effects on borrowing costs, may dissipate.

4. **The costs of fiscal complacency are likely to rise in the years to come.** Without deep-rooted reforms, public debt will rise rapidly in the near future as privatization receipts dry up and a large volume of state-guaranteed loans are called. We estimate that by 2006, general government debt will about double as a share of GDP. With current interest rates well below those in other EU accession countries, and even below levels in the euro zone, there is no room for markets to reward the Czech Republic for good fiscal performance, only to punish it for failing to take adequate measures in a timely manner. Thus, while other accession countries can expect to benefit from a virtuous cycle of fiscal retrenchment and declining interest costs, the Czech budget will face higher interest payments (a conservative estimate is that annual interest payments could rise by 2 percent of GDP), necessitating even larger cuts in other types of spending to reach a given fiscal target. The recent downgrade of local-currency Czech debt by one credit rating agency should be seen as a warning.

5. **Looking beyond 2006, the outlook is even more worrisome.** As the bulk of public pension spending is determined by legal commitments made many years earlier, the absence of strong pension reform to date, despite the rapidly aging population, will lead to a sharply expanding pension system deficit from 2010. Fiscal pressures will also increase in areas such as health care expenditures. Although rapid deterioration in the deficit is not imminent, demographic trends foreshadow an explosive growth in public debt which will trigger hikes in borrowing costs, and place public finances on an unsustainable path.

6. **The economic costs of delaying deficit reduction are significant.** A large deficit squeezes the room available for countercyclical policies during periods when economic growth falls below potential. Large government spending can also place upward pressure on inflation and current account deficit, and force the monetary policy stance to be tighter than otherwise desired. In addition, a greater borrowing requirement by the government could crowd-out bank lending to domestic small- and medium-sized enterprises at a time when their credit demand is picking up as corporate restructuring proceeds and export-oriented investment opportunities open up, thereby hindering medium-term growth. A myopic view of the fiscal outlook may tempt policymakers to delay painful pension reform measures until sustainability problems become obvious. However, postponing the adjustment needed for ensuring long-term sustainability is likely to render any solution ultimately more costly, both for the public purse and in terms of overall economic welfare.

7. **An additional reason for the Czech Republic to reduce the fiscal deficit is avoid falling behind other EU accession countries planning to adopt the euro.** In order to qualify for euro membership, the Maastricht criteria must be satisfied which, on the fiscal side, requires a deficit of 3 percent of GDP or less, and public debt of 60 percent of GDP or less. After adopting the euro, countries must comply fully with the more stringent Stability

and Growth Pact, which requires a position of medium-term budget balance. Other transition economies in the first wave of EU enlargement have either met already the Maastricht fiscal criteria, or are aiming to do so within the next few years. Therefore, there is a significant risk that the Czech Republic will be among the few countries—or even the only country—to be left behind due to its slow pace of deficit reduction. It is not clear whether entering the euro zone in the shortest permissible amount of time after EU accession, or even as soon as most other countries intend to join, is the best economic decision for some accession countries, as a case could be made for waiting until more real convergence has taken place so that the economy will be better suited for entry. However, it is advisable to have the *discretion* to choose the appropriate time for adopting the euro, which would require the country to have fully qualified to do so at an early stage. The reason for this is the risk that financial markets may well punish the economic laggards, leading to a loss of market confidence, with adverse repercussions for the exchange rate, interest rates, and investment, including foreign direct investment. Such developments would make meeting the Maastricht fiscal and other criteria that much more difficult.

8. **Against this background, the fiscal path chosen by government and parliament in the next few years is of critical importance.** We are encouraged that the government's Coalition Agreement includes an improvement of the public finances as a main policy objective, and views reforms of public finances to be prepared and implemented during 2003-06 as a necessary condition for achieving quick entry into the euro zone. The government's four-year fiscal plan with binding limits on spending by individual budgetary chapters (to be formulated and published by mid-December) will be a key tool for setting the agenda for the current government's term and for convincing markets of its commitment to sustainable deficit reduction. In discussions with the mission, Ministry of Finance officials acknowledged the risks to investor confidence of an insufficiently ambitious framework, and were fully aware that deficit targets must be supported by concrete and credible policy measures. They considered institutional reforms (including, if necessary, legislative action to achieve them) that would cut future deficits or increase the consistency and transparency of the budgeting process as indispensable complements to the expenditure ceilings.[2]

9. **Discussions with line ministries and extrabudgetary funds revealed divergent views and plans.** Some saw inefficiencies in their current operations and offered specific suggestions for remedies or possible spending cuts.[3] Others saw the need to maintain or even

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[2] Over the past few years, some significant steps have already been taken to increase the transparency of public finances, such as incorporating the operations of CKA into government deficits and debt and, most recently, the decision to record as government debt the liabilities of Czech Railways (most of which are state guaranteed).

[3] Problems can arise from the failure of policy design to recognize the role of incentives. If a policy measure creates inappropriate incentives, the measure will not achieve its intended purpose, and could also raise the level of government spending relative to a better-targeted measure. The government's recent proposal to shift to firms responsibility for the initial

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increase their spending, citing unfinished transition- and accession-related investment requirements. Satisfying reasonable demands for new priority expenditures while reducing the deficit will require a willingness to compromise and a sharing of responsibility between the different ministries, the central, local and regional governments and, most importantly, between the political parties.

10. **The mission looks forward to reviewing the government's medium-term fiscal plan later in the year.** We understand that the broad outlines of the document have already been set, but that some details are yet to be finalized. With this in mind, we would like to offer some suggestions to bolster the success of the framework while also promoting a favorable reaction from financial markets.

- **An ambitious deficit target path should be pursued.** In its Coalition Agreement, the government announced that the general government deficit target for 2006 would not exceed 4.9-5.4 percent of GDP. Even at the bottom of this range, however, the deficit would be almost 2 percent of GDP above the Maastricht ceiling, precluding euro adoption in 2007, the year in which many other first-wave accession countries are aiming to join. In addition, most of the needed fiscal correction to be able to adopt the euro before the end of the decade would be left to the next government. Such timing of the adjustment—slow deficit reduction in the next few years followed by a sharp compression—would seriously constrain fiscal policy's room in later years to cushion any adverse macroeconomic shocks that may occur. To safeguard against this, and to minimize the risk of an adverse market response to deferred fiscal reform, achieving—or at least aiming to move close to—a 3 percent deficit by 2006 is recommended. As explained above, this would not oblige the Czech Republic to adopt the euro in the first group.

- **Deficit reduction should be achieved primarily through expenditure restraint.** In view of an expected increase in factor mobility after the Czech Republic enters the EU, and international trends toward lower taxation, taxes should not be raised beyond levels required for EU harmonization. However, there is room to reduce distortions within the existing tax system, including by raising the base for social security contributions of the self-employed. The introduction of small user fees and co-payments for some public services, for example, in health care and education, could help better allocate public resources and reduce the need for tax financing. However, this will provide only a partial solution. Thus, expenditures will have to contract.

- **Within this expenditure envelope, existing spending programs should be judged against policy priorities.** In order to devise a list of measures to durably reduce government spending, existing spending programs should be reviewed and evaluated, using the criteria of cost-effectiveness, efficiency, growth-enhancement, fairness, and consistency.

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period of sick pay aims to alleviate such a situation by giving firms the correct incentive to grant sick leave to those who are truly sick.

This review, the results of which should be made public, could form the basis for modifying, eliminating and, in a few cases, adding spending programs. Priority should be given to changes aimed at permanent expenditure reduction. Some of these measures, especially those affecting pensions, will yield greater savings over time and help secure future deficit targets.

- **Commitment to the deficit reduction path should be demonstrated by preparing the necessary legislative changes.** Those measures that are solely at the discretion of the central government can be implemented relatively quickly. For those that require legal amendments—and, therefore, whose implementation will be delayed—draft legislation should be prepared expeditiously and submitted to parliament in order to support the credibility of the program.

- **Transparent institutional mechanisms would help ensure the consistency of, and adherence to, the medium-term plans.** Control over budget formulation and execution by the Ministry of Finance should be strengthened, including by integrating back into the state budget the extrabudgetary funds for transport infrastructure and housing, as well as securing instruments to limit deficits of local governments. Specifying contingency plans to be activated in the event of a temporary cyclical downturn, other adverse circumstances, or slippages in the implementation of some measures, will help ensure that transitory deviations do not derail the entire deficit reduction path. Rolling multi-year budget preparation, encompassing both top-down and bottom-up approaches, allows for better long-term planning, especially as regards expenditure programs that run over several years, thereby ensuring that adequate resources will be available for the entire project.

11. **Last, but most important, a solid political consensus is needed to implement the medium-term plans without watering down their execution.** The mission looks forward to the government's strong initiative and leadership in mobilizing broad political support from the general public.