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Public finance consolidation in V4 plus Ukraine

COMPENDIUM OF COUNTRY-SPECIFIC ANALYSES

INEKO and partners

Edited by Peter Goliaš, INEKO

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The document offers an overview of the public finance development in Visegrad 4 countries and Ukraine mostly over the period 2008-2018. It comprises five country-specific analyses presented in a closed webinar “Public Finance Consolidation” that took place on May 22nd, 2015 under the project “Hidden Triggers of Economic Growth in V4 plus Ukraine”; see also http://www.ineko.sk/projekty/visegrad-fund.

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Project partners:

- INEKO – Institute for economic and social reforms (Slovakia; http://www.ineko.sk/); leading partner
- The Polish Institute of International Affairs (Poland; http://www.pism.pl/)
- Centre for Economic and Regional Studies of the Hungarian Academy of Sciences (Hungary; http://vki.hu/)
- Centre for Economic and Market Analysis (Czech Republic; http://eceta.cz/)
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Introduction

All Visegrad countries (i.e. the Czech Republic, Hungary, Slovakia and Poland) have decreased their structural budget deficits below 3% of GDP by 2014 and, consequently, exited the Excessive Deficit Procedure – corrective arm of the Stability and Growth Pact of the EU. The external pressure from the European Commission played a crucial role in stabilizing their public finances after the crisis hit their economies in 2009 and 2010. In Poland and Slovakia also the internal debt brake rules added substantially to this pressure.

The implemented consolidation measures included increase in the retirement age (Poland), increase in direct income taxes and increase in the efficiency of tax collection (Slovakia), increase in VAT taxes (Poland, Slovakia), temporary freezing of public workers' salaries (Poland, Hungary, Slovakia), cuts in several social benefits (all Visegrad countries) and many others.

The Czech Republic and Slovakia have reasonable chances to balance their budgets structurally by 2018. In Poland and Hungary this may take a longer time.

In terms of the public debt, the Czech Republic had the lowest level of 42.6% of GDP in 2014 followed by Poland with 50.1%, Slovakia with 53.6% and Hungary with 76.9% of GDP. In Poland and Hungary, substantial reduction of the public debt was achieved by one-off measures transferring assets from the private to the public pension scheme which will, however, increase public expenditure on pensions in the long-term. The same happened also in Slovakia, although to somewhat lesser extent.

Compared to rather stable public finances in Visegrad 4 countries Ukraine faces major economic crises caused by a dramatic political development and consequent armed conflict in the eastern regions of Donetsk and Luhansk. According to the International Monetary Fund (IMF), the public debt soared from 41% of GDP at the end of 2013 to 73% at the end of 2014 and is expected to reach 94% at the end of 2015. In fact, the country came to the brink of bankruptcy and relies on an international financial support.

The current priority for Ukraine is to stabilize the security and macroeconomic situation. At the same time it has to adopt series of structural reforms to create basis for sustainable development. Here, it can take a lot from the reform experience of the Visegrad 4 countries. In terms of the public finance consolidation, the main lessons include increasing transparency in public finances reporting, implementing internal debt brake rules, improving efficiency in tax collection, stabilizing the pension system, designing the motivational tax and social benefits systems and many other measures.

In fact Ukraine has already started to implement necessary changes for example by cancelling a number of tax exemptions and simplifying the tax system in 2014 or by recent deregulation of the gas prices. Together with the IMF it has also outlined an ambitious plan for further reforms. It will be crucial that the international community supports Ukraine in its reform effort. The Visegrad countries can and should give it a hand. Transferring their reform experience is a unique and very efficient opportunity. It is also in their utmost interest because due to geographical and cultural proximity, the Visegrad countries would be among countries mostly benefiting from the stable and prosperous Ukraine.

ANALYSIS 1: Public finance consolidation in Slovakia

Peter Golias, INEKO, Slovakia

May 2015

The Institute for economic and social reforms (INEKO) is a Bratislava-based non-governmental non-profit organization established in support of economic and social reforms which aim to remove barriers to the long-term positive development of the Slovak economy and society. See also http://www.ineko.sk/.

Summary: The document offers a brief overview of the public finance consolidation in Slovakia over the period 2008-2018. Slovakia decreased public finance deficit from almost 8% of GDP in 2009 to less than 3% in 2014 and plans to decrease it further to less than 0.5% in 2018. Two major consolidations appeared in 2011 – mostly on expenditure side and in 2013 – mostly on revenues side. At the same time, Slovakia succeeded in stabilizing the public debt growth that almost doubled from 28.2% of GDP in 2008 to 54.6% in 2013; then decreased to 53.6% in 2014 and should decrease further to 50.3% of GDP in 2018. Besides public finance deficit reduction the reform to the pay-as-you-go (PAYG) pension system adopted in 2012 helped significantly to improve the long-term sustainability of the public finance when the GAP indicator decreased from over 9% of GDP in 2009 to less than 2% in 2013. After the 2009 crises, major consolidation measures included cutting public expenses in 2011, binding the retirement age to longevity and gradual introduction of pension valorization by inflation legislated in 2012, as well as raising taxes and improving tax collection efficiency since 2013. To guard public finance stability the constitutional law enacted public debt brakes and established the Council for Budget Responsibility in 2012. The case of Slovakia shows that internal rules guarding public finances might work well if legislated by constitutional majority and controlled by high-quality and credible people in the leadership of the guarding body. The European Commission helped a lot by strengthening its oversight especially under the Excessive Deficit Procedure imposed on Slovakia in 2009-2013. The ESA2010 standards helped to disclose some hidden debt; nevertheless the PPP projects and the old debt of public hospitals remain off-balance.

Introduction: According to Eurobarometer survey, people in all Visegrad countries (Czech Republic, Hungary, Poland, and Slovakia) consider the government debt to be among the top problems faced by their country. In all countries people list unemployment as the biggest problem. In the Czech Republic government debt is on the second place, in all other countries it is on the 5th or 6th place. Paradoxically, the gross public debt is the lowest in the Czech Republic – 42.6% of GDP in 2014. For comparison, it was 53.6% of GDP in Slovakia or 76.9% in Hungary (see Tables 1 and 2). It is difficult to explain this paradox. One of hypothesis might be that the more people think public debt is the problem the bigger is the pressure on government to reduce it.

Table 1: Most important issues faced by the country

Czech Republic	Hungary	Poland	Slovakia
Unemployment (40%)	Unemployment (50%)	Unemployment (54%)	Unemployment (57%)
Government debt (27%)	Economic situation (30%)	Health care system (25%)	Economic situation (31%)
Rising prices/Inflation (24%)	Health care system (21%)	Rising prices/Inflation (19%)	Health care system (23%)
Economic situation (20%)	Rising prices/Inflation (20%)	Pensions (19%)	Rising prices/Inflation (21%)
Crime (20%)	**Government debt (13%)**	Economic situation (17%)	Pensions (13%)
Pensions (17%)	Pensions (13%)	**Government debt (11%)**	**Government debt (11%)**

Source: Eurobarometer, November 2014

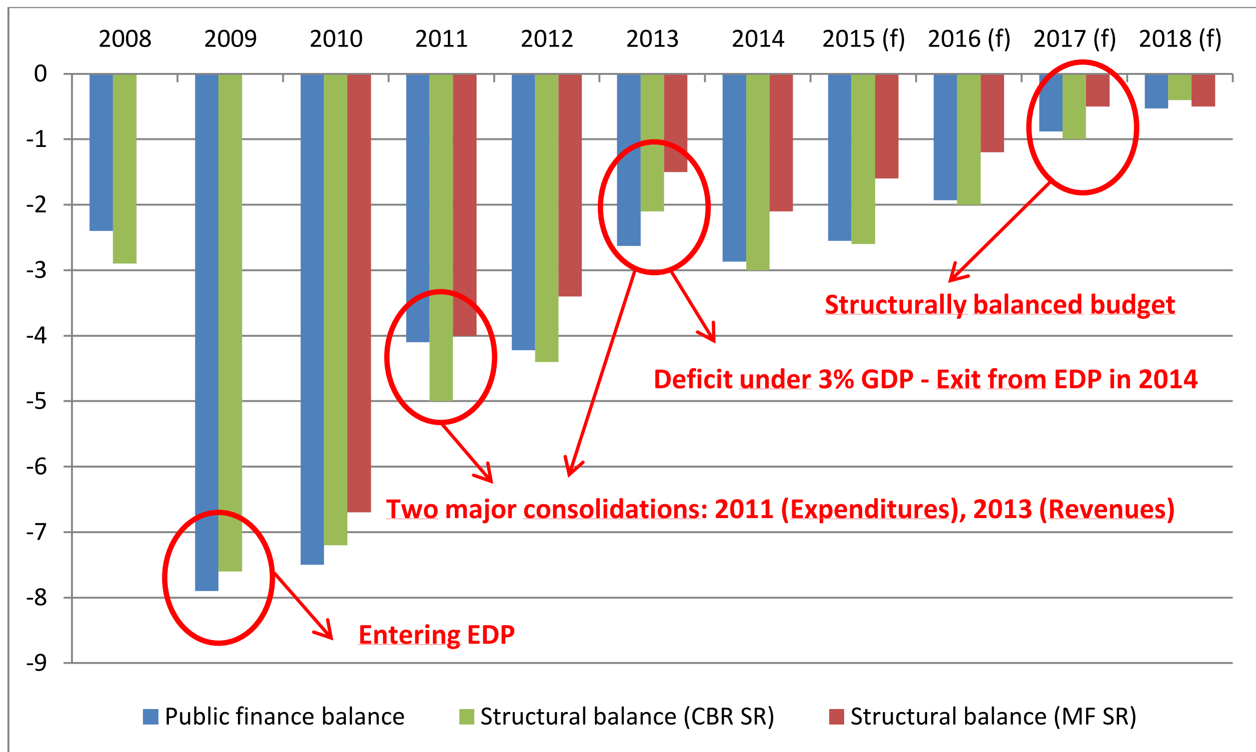
Table 2: Gross public debt (% GDP, 2014)

Czech Republic	Hungary	Poland	Slovakia
42.6	76.9	50.1	53.6

Source: Eurostat

Public finance balance: The crises blew up the public finance deficit in Slovakia from 2.4% of GDP in 2008 to 7.9% in 2009. After two major consolidations in 2011 – mostly on expenditure side and in 2013 – mostly on revenues side, the deficit decreased to less than 3% in 2014 and the Ministry of Finance plans to decrease it further to less than 0.5% in 2018. As shown in Figure 1, Slovakia entered the Excessive Deficit Procedure imposed by the European Commission in 2009 and left it in 2014. The deficit increased in 2014 but remained under 3% threshold.

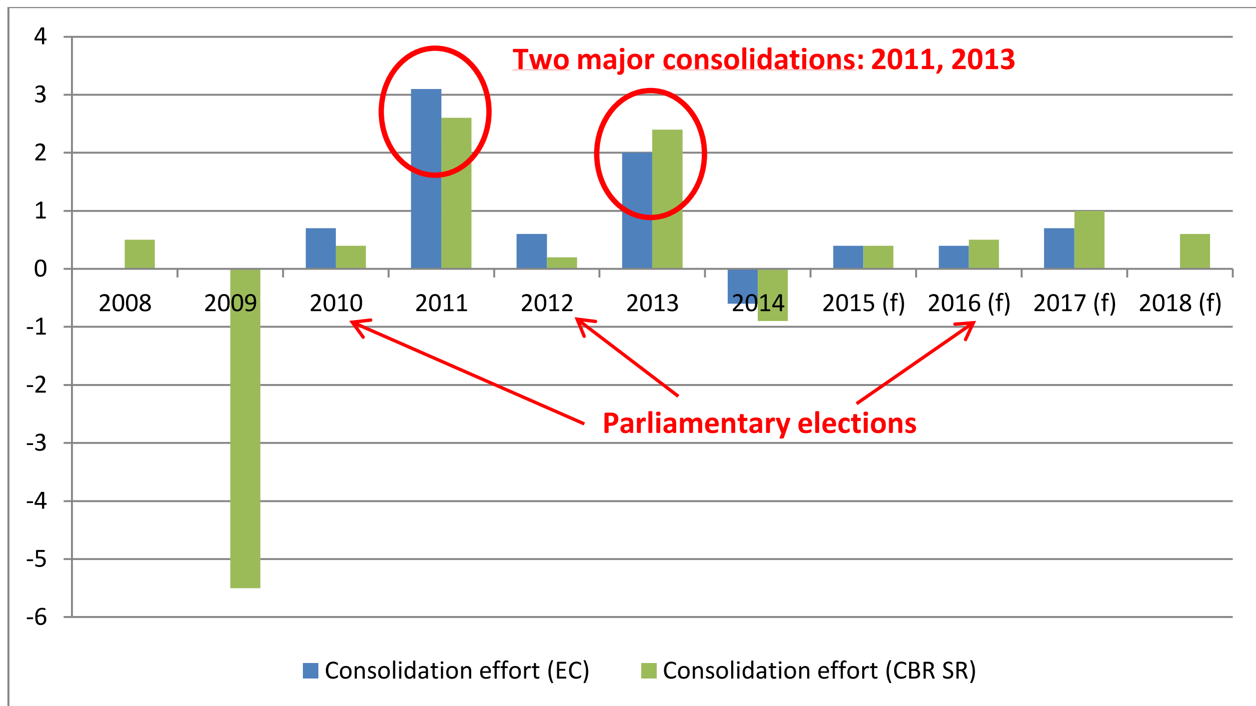
Figure 1: Public finance balance in Slovakia (% GDP)



Sources: Ministry of Finance (MF SR), Council for Budget Responsibility (CBR SR)

The Ministry of Finance plans to have structurally balanced deficit (i.e. cleared by one-off measures and economic cycle) by 2017. To achieve this goal the consolidation must continue in 2015- 2017. However, in March 2016 there will be parliamentary elections which might prove it difficult to cut the deficit especially in 2015 and 2016. The Figure 2 shows that the major consolidations in 2011 and 2013 came one year after the parliamentary elections. Therefore it will be crucial what will be the size and structure of measures adopted by a new government coming into power after 2016 elections.

Figure 2: Consolidation effort – change in structural deficit (% GDP)

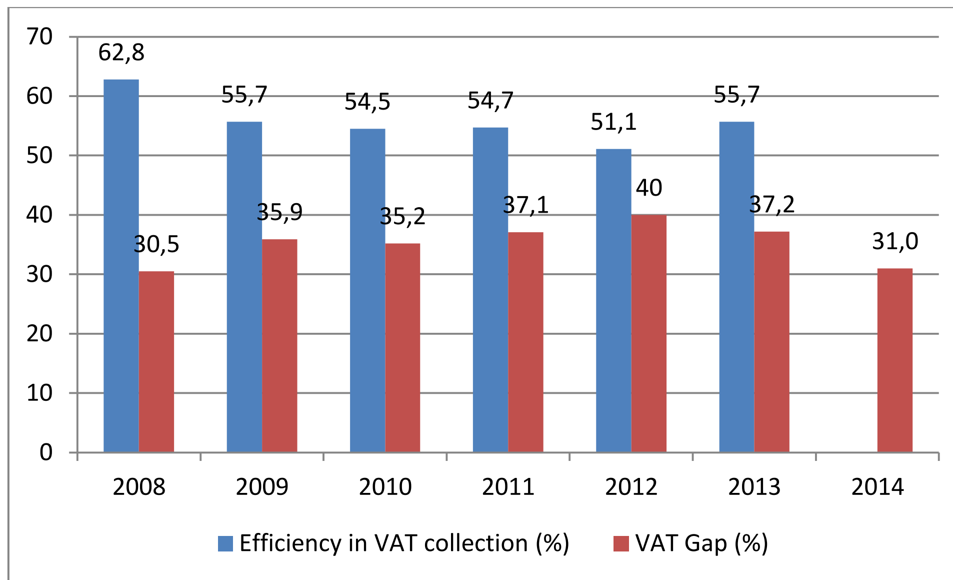


Sources: INEKO based on data from the Ministry of Finance using methodology of the European Commission (EC) and from the Council for Budget Responsibility (CBR SR)

The 2011 consolidation included cuts in expenditure on public procurement, staff remuneration and also increasing the value-added tax (VAT) from 19% to 20%.

The 2013 consolidation included increasing corporate income tax from 19% to 23% (since 2014 decreased to 22%), introducing higher rate of the personal income tax for top-earners at 25% (lower rate remained at 19%), increasing social contributions for top-earners, increasing taxes for self-employed, as well as introducing special tax levies for regulated monopolies and financial institutions. Besides increasing taxes the government adopted around 50 measures with the aim to improve tax collection. From among them the most important included more targeted effort to disclose fraud cases (establishing “tax-cobra” commando), introducing electronic central evidence of invoices enabling cross controls, increasing tax transparency (publishing taxes paid by firms), extending “reverse charge” VAT payment mechanism with the VAT paid by buyers, extending the use of registration machines (i.e. by hotels, physicians, taxi drivers, etc.), more targeted controls of transfer prices, etc. The results became evident in 2013 when the efficiency in VAT collection increased from 51.1% to 55.7% (see Figure 3) and the VAT gap decreased from 40% in 2012 to 31% in 2015. Thus the additional VAT revenues brought by the improved efficiency in collection amounted to more than 1% of GDP in 2014 compared to 2012.

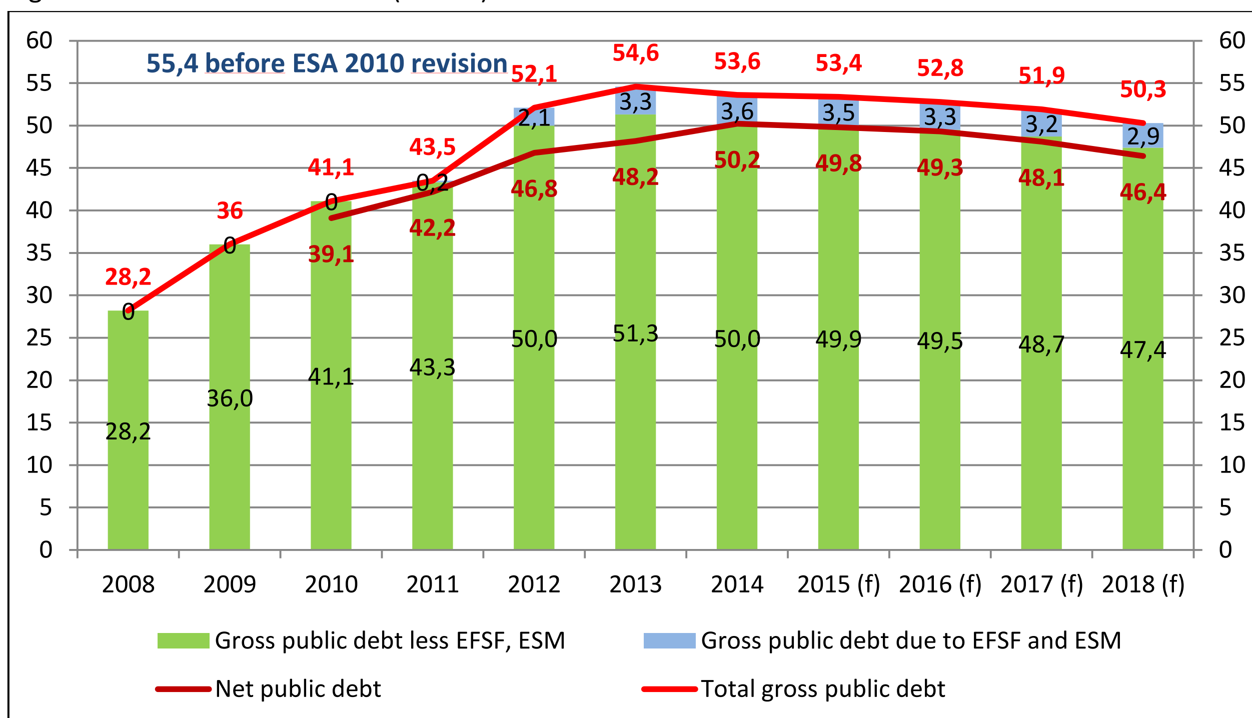
Figure 3: Efficiency in VAT collection



Source: MF SR

Public debt: Slovakia succeeded in stabilizing the public debt growth that almost doubled from 28.2% of GDP in 2008 to 54.6% in 2013; then decreased to 53.6% in 2014 and should decrease further to 50.3% of GDP in 2018. Since 2012 the public debt has been increased by 2.1-3.6 percentage points due to participation of Slovakia in the European Financial Stability Facility (EFSF) and later in the European Stability Mechanism (ESM), i.e. mostly by the guarantees provided by Slovakia for the debt of Eurozone countries unable to pay their liabilities after the crises. The net public debt, i.e. gross debt less the liquid assets peaked at 50.2% of GDP in 2014 and is expected to decline to 46.4% by 2018.

Figure 4: Public debt in Slovakia (% GDP)



Source: INEKO based on data from the Ministry of Finance (MF SR)

The debt growth stabilization was supported by the Constitutional Act on Budget Responsibility adopted in 2012 introducing the debt brakes and the new institution for guarding public finance stability – the Council for Budget Responsibility. The Act introduced following levels of public debt brakes:

- Public debt at 50% of GDP:
  - The Ministry of Finance has to inform the National Parliament about reasons of surpassing the debt level and about the measures to decrease the public debt.
- Public debt at 53% of GDP:
  - The Government has to propose to the National Parliament measures to reduce the debt; the salaries of the Government Members are frozen.
- Public debt at 55% of GDP:
  - Additionally to measures adopted under previous levels, the Government has immediately to cut 3% of the state budget expenditure (less the expenditure on (1) public debt service, (2) relations with the EU, (3) transfers from the state budget to the Social Insurance Agency and (4) liquidation of damages caused by natural catastrophes).
  - For the next year the government has to freeze the public finance expenditure (less the expenditure on (1) public debt service, (2) relations with the EU, and (3) liquidation of damages caused by natural catastrophes).
  - At the same time the municipalities have to freeze their expenditure for the next year (less the expenditure on (1) relations with the EU and (2) liquidation of damages caused by natural catastrophes).

    - Moreover, the Government has to stop drawing money from its reserve and from the reserve of the Prime Minister.
- Public debt at 57% of GDP:
    - Additionally to measures adopted under previous levels, the Government and the municipalities have to propose balanced budgets for the next year.
- Public debt at 60% of GDP:
    - Additionally to measures adopted under previous levels, the Government has to ask the National Parliament for the vote on confidence.

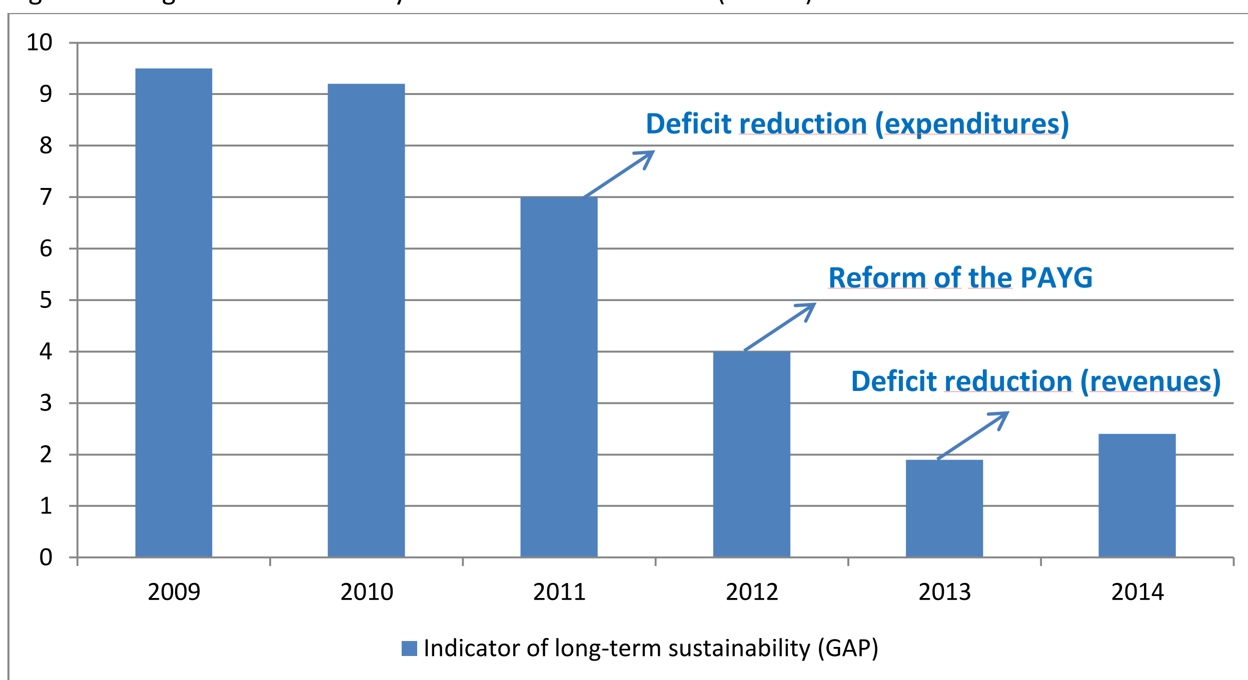
These debt brake levels are valid until 2017. In the transition period from 2018 until 2027 the limits will be decreasing gradually by 1 percentage point every year to final 40% for the lowest level and 50% for the highest level.

As shown in Figure 4 the 50% limit was surpassed in 2012 and the 53% limit was surpassed both in 2013 and 2014. In fact, early in 2014 the Eurostat confirmed even surpassing the 55% limit with the debt at 55.4% of GDP in 2013. However later due to adopting new ESA2010 methodology and especially new methodology for GDP calculation the debt level for 2013 was revised down to 54.6% of GDP.

The ESA2010 standards helped to disclose some hidden debt; nevertheless the PPP projects and the old debt of public hospitals remain off-balance. The biggest liabilities from PPP projects stem from the project on building a highway R1 in the amount of 2.7% of GDP. The old debts of state hospitals amount to 0.6% of GDP. Other hidden debt includes the off-public-balance-sheet debt of state and half-state firms (e.g. debt taken to pay-out the super-dividends; debts of firms owned by municipalities, etc.) as well as liabilities conditioned on ongoing court processes or state guarantees. The methodology for calculating this debt has not yet been set but the Congressional Budget Office estimated the conditional debt at 16.4% of GDP as of 2013; out of which 3.0% of GDP is EFSF.

Long-term sustainability: Besides public finance deficit reduction the reform to the pay-as-you-go (PAYG) pension system adopted in 2012 helped significantly to improve the long-term sustainability of the public finance when the long-term sustainability GAP indicator decreased from over 9% of GDP in 2009 to less than 2% in 2013. After the 2009 crises, major consolidation measures included cutting public expenses in 2011, binding the retirement age to longevity and gradual introduction of pension valorization by inflation legislated in 2012, as well as raising taxes and improving tax collection efficiency since 2013.

Figure 5: Long-term sustainability GAP indicator in Slovakia (% GDP)



Source: INEKO based on data from the Ministry of Finance (MF SR) and the Council for Budget Responsibility (CBR SR)

The 2012 reform of the PAYG pension pillar contributed heavily to the stabilization of the pension system by halving its long-term deficit. However it did not solve the entire problem. According to the Institute for Financial Policy at the Ministry of Finance[1], the pension system deficit is expected to decrease from 1.4% of GDP in 2013 to 1.1% in 2030 but than to increase to 3.7% of GDP in 2060.

The 2012 reform included following major changes:

- Prolonging retirement age: In 2004-2006 the retirement age of men went up from 60 to 62 years. Since 2004 also the retirement age of women has been increasing gradually up to final 62 years. The 2012 reform enacted that from 2017 the retirement age of both men and women will be linked to life-expectancy.
- Indexing pensions: The 2004 reform enacted automatic pension valorization by the index computed as an average of wage growth and inflation. The 2012 reform introduced a transition period from 2012-17 in which the pensions are being valorized by a fixed sum computed as the weighted average of wage growth and inflation divided by the average wage in the economy. The weight of inflation is gradually increasing. From 2018 the pensions will be indexed purely by the inflation for basket of goods bought by pensioners.

Besides changes to the PAYG pillar the government adopted several changes to the second fully-funded pension pillar that helped it to stabilize the public finance. The impacts of these changes on the public

[1] Source: http://www.finance.gov.sk/Default.aspx?CatID=10181

finance balance are positive or neutral until 2060 and increasingly negative afterwards. The most important changes included:

- Reducing the contribution rate to the fully-funded pillar from 9% of gross earnings to 4% with the effect from September 2013. This change has increased public finance revenues by around 0.6% of GDP annually. The rate is expected to grow up gradually to 6% by 2024.
- The government has four times re-opened the second pillar (in 2008, 2008/09, 2012/13, and 2015), i.e. it allowed people inside to return their full contributions back to the PAYG. During first three re-openings approximately 15% of people returned back to the PAYG.
- In 2008 and (after temporary restatement) repeatedly in 2013 the government introduced voluntary entry for young people, i.e. the young people entering the labor market are by default paying their full contribution to the PAYG unless they actively decide to enter the second pillar.

Current challenges and lessons learned: The need for public finance stability is becoming less imminent and the problem is less visible in the public discourse after reducing public finance deficit below 3% of GDP and public debt below 55% of GDP. The top government priorities reflecting people's concerns include high unemployment (especially long-term) and low quality of public services (especially in health care and education). Nevertheless the expert attention is still focused on following areas related to the public finance stability:

- Inefficiency and high indebtedness of the health care system; long-term predictions of growing deficit in health care and long-term care mainly due to demography changes.
- Long-term pension deficit predictions, growing after 2030.
- Inefficient use of the funds of the European Union which is resulting in substantial "corrections" meaning that the European Commission refuses to pay for some projects and the money has to be provided from the state budget increasing the public finance deficit.
- Further improvement of tax collection efficiency; increasing revenues from the real estate taxes; deepening tax transparency.

The case of Slovakia shows that internal rules guarding public finances might work well if legislated by constitutional majority and controlled by high-quality and credible people in the leadership of the guarding body. The European Commission helped a lot by strengthening its oversight especially under the Excessive Deficit Procedure imposed on Slovakia in 2009-2013 but also by introducing the Fiscal Compact, disclosing some of hidden debts under ESA2010 and strengthening the Stability and Growth Pact. Importantly, the public discourse supportive for fiscal prudence helps a lot with major roles played by media, think-tanks, and economic analysts. As an example of think-tank initiative, early in 2014 the INEKO institute launched a computer game (see http://hra.ineko.sk/) aiming to educate public about the need of public finance consolidation. The game is based on the actual long-term public debt projections. The goal is to decrease public debt by 2062 as much as possible. The game allows for choosing from over 200 consolidation measures and limits the player's options based on his/her political support which depends on measures already taken. The biggest news portal SME.sk displayed the game on its website and helped to attract several tens of thousands of players shortly after launching the game.

ANALYSIS 2: Public finance consolidation in Hungary

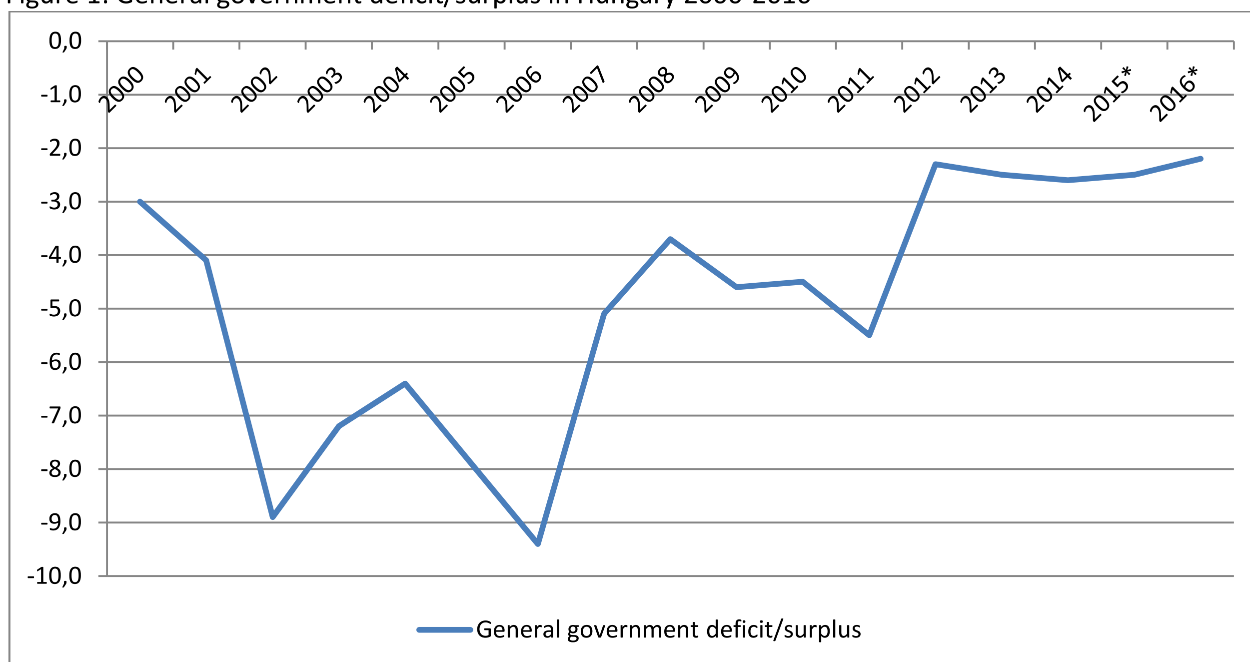
Ágnes Orosz, IWE MTA KRTK, Hungary

May 2015

The Institute of World Economics of the Centre for Economic and Regional Studies of the Hungarian Academy of Sciences focuses on global economic trends and their effects on Hungary. It is the oldest and most experienced institute in this field in Hungary. As the successor to the Institute for World Economics founded in 1973, the Institute adopted its current name and structure on January 1st, 2012. See also http://vki.hu/home.html?setlang=english.

Summary: Public finance deficit was a constant problem in Hungary during the 2000s before the outbreak of the financial and economic crisis. As percentage of GDP general government deficit peaked at 9.4% in 2006 (*Figure 1*). Substantial fiscal consolidation in Hungary began in mid-2006, with the fiscal deficit falling from 9.4% to 5.1% in the subsequent year in 2007, therefore the government was able to stabilize debt-to-GDP ratio.

Figure 1: General government deficit/surplus in Hungary 2000-2016



Source: Eurostat, forecasts (*) based on European Commission Spring 2015 Economic Forecast: Tailwinds support the recovery

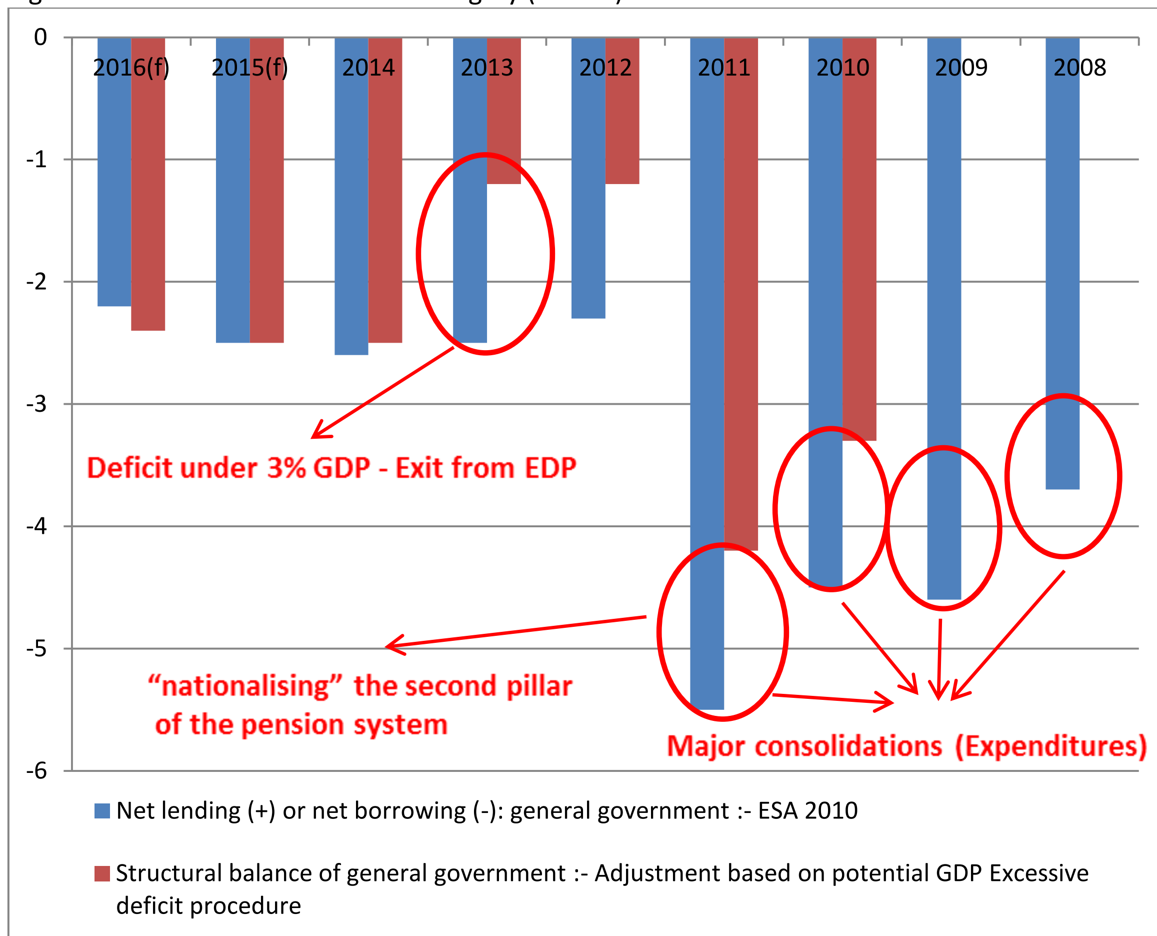
Public finances in Hungary were among the worst ones in the EU before the outbreak of the 2007/08 crisis. The country was under excessive deficit procedure between 2004 and 2013, this period was characterised by steady increase of public debts. Consequently Hungary could not pursue an anti-cyclical economic policy in the crisis on the contrary; it had to introduce fiscal austerity in the middle of recession (Vida, 2012). Hungary requested a Stand-By Arrangement (SBA) from the IMF in October 2008,

shortly after the culmination of the worldwide financial market crisis. The EU agreed and joined the IMF in providing Hungary additional financial support by using its Balance-of-Payments (BoP) Assistance Facility (total amount was to € 20 billion in which IMF: € 12.3 billion, EU: € 6.5 billion, World Bank: € 1.0 billion) (Seitz – Jost, 2012).

Hungary decreased public finance deficit from around 5 per cent of GDP in 2011 (similar level as in 2009 and 2010) to less than 3% in 2012 and onwards, so deficit can be maintained below the 3 per cent threshold. Forecast for 2015 and 2016 shows deficit levels below the threshold (EC, 2015a).

Public finance balance: Public finance deficit skyrocketed even before the outbreak of the financial and economic crisis. As to public finances, the Hungarian performance has been among the worst ones in the EU before the crisis. In 2008 after successful consolidation the government was able to decrease general government deficit to 3.7%. Gross domestic product shrunk to nearly 7% in 2009 – well below the average recession rate of the EU27 (-4.3%), and deficit increased to 4.6 per cent in 2009. The approximately 5 per cent deficit level remained until 2010. After several remarkable consolidation the deficit decreased to less than 3% in 2012 and deficit can be maintained below the 3 per cent threshold. The Hungarian government plans to gradually improve the headline deficit to 2.4% of GDP in 2015 and further to 1.6% in 2018 (EC, 2015b).

Figure 2: Public finance balance in Hungary (% GDP)



Source: AMECO database

2008 and the following years were time of significant fiscal consolidation packages, after a period of large budget deficits and accumulation of public debt that lasted over a decade.

In 2008, the focus of applied measures was on the expenditure side, including pay cuts for public-sector employees, equivalent to 1% of GDP, the elimination of the 13th monthly pension for early retirees and a cap on the 13th monthly pension for other pensioners, equivalent to 0.2% of GDP. The indexation of selected social benefits was to be postponed or eliminated (0.2% of GDP), and other spending was to suffer a general reduction (0.5% of GDP) (Myant et al., 2013). In 2009 social spending cuts translated into cutbacks in universal provisions and social insurance (Matos, 2013).

In 2009 and 2010 expenditures were reduced by the equivalent of 1.6% and 3.6% of GDP, respectively, including cuts in pensions, by various means, and cuts in various social benefits. Public-sector pay was frozen for 2010 and 2011 and cut through abolition of the 13th-month salary from 2009. The dominant features of crisis management in Hungary were to remain a shift towards a less progressive tax system, cuts in redistributive state spending, most notably on the unemployed (Myant et al., 2013). In 2010 the government reduced the personal income tax effective to a flat rate system at 16 percent, which had an increase in labour participation as main objective (Guerson, 2013).

In late 2010, the government of Hungary decided to nationalize private pension funds, drifting away the Hungarian mixed pension system from private insurance, reinstalling the pay-as-you-go scheme (Matos, 2013). The nationalised pension capital (9 per cent rather than the original 11 per cent of GDP) has been targeted not only to reduce the budget deficit (5 per cent of GDP), but for making room for a radical tax cut (cc. 4 per cent of GDP during three years). However Simonovits (2011) argues that the implicit government debt would be increased by the gains in future pension entitlements of those returning to the mono-pillar.

In 2011 the Hungarian government launched the Szell-Kalman Plan, a reform program that focused on fiscal consolidation and structural reform in order to implement ambitious fiscal reforms between 2012 and 2013, of which around three fourth were expenditure-based. The reforms targeted a broad set of areas including on health, education, social transfers, pensions, local administrations, and transport. During 2011-2012, there were savings in the expenditure areas of goods and services, public wages, and transfers to households totalling over 2 per cent of GDP (Guerson, 2013).

Year 2012 brought large vulnerabilities and limited space to absorb shocks, financial pressures rose sharply in the wake of growth and financial spillovers from the Eurozone crisis, which exacerbated existing strains on the domestic economy. However, despite these pressures, the authorities managed to maintain macroeconomic stability. From 2012 onwards the authorities have placed job creation as a key policy objective and have adopted measures to stimulate employment, including by tightening unemployment and welfare benefits, expanding the public works program, and reducing tax rates and social contributions for some segments of the labour force (IMF, 2013).

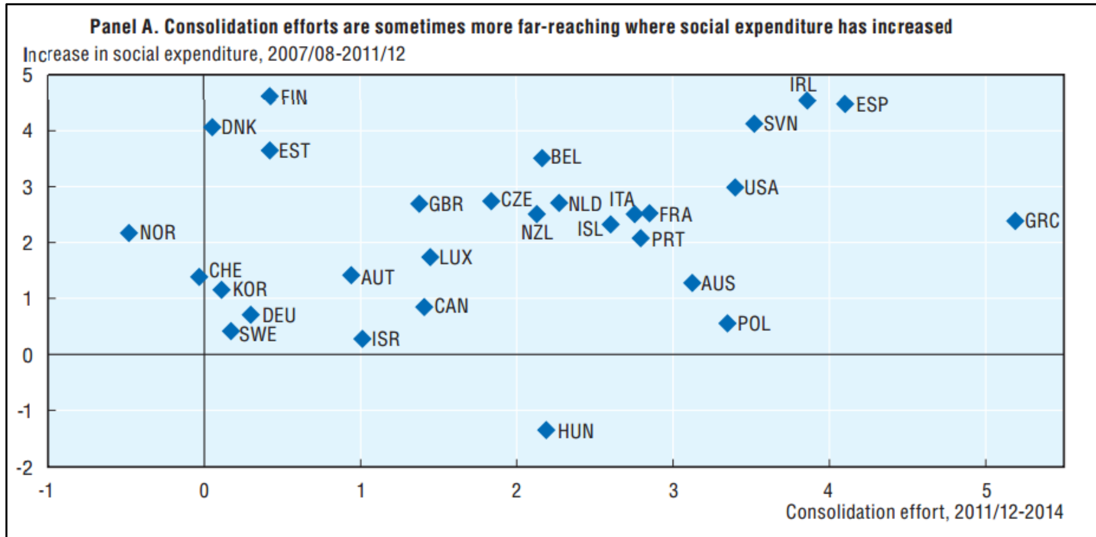
In 2013 authorities introduced two additional fiscal consolidation packages, one targeting the expenditure side and the other mainly raising and redesigning sector-specific taxes. Overall, the deficit remained and expected to remain below 3 per cent of GDP. Official plans suggested underlying fiscal expansion and a slight increase in the headline deficit amidst a recovery in activity and a broadly neutral fiscal stance in 2015-2016 (OECD, 2014).

In its 2015-2018 Convergence Programme, the Hungarian government plans to gradually improve the headline deficit to 2.4% of GDP in 2015 and further to 1.6% in 2018, and that the medium-term objective – a structural deficit of 1.7% of GDP − is reached by 2017. According to the Convergence Programme, the government plans to gradually reduce the debt-to-GDP ratio to 74.9% in 2015 and to 68.9% in 2018 (Magyarország Kormánya, 2015). The macroeconomic scenario underpinning these budgetary projections is broadly plausible until 2016 and becomes favourable thereafter. Measures to support the planned deficit targets from 2016 onwards have not been sufficiently specified, in particular beyond 2016. Based on the Commission's 2015 spring forecast, both the structural balance and net expenditure growth point to a risk of a significant deviation from the required adjustment path towards the medium-term objective in 2015 and 2016. Therefore, further measures will be needed in 2015 and 2016 (EC, 2015b).

In general it can be concluded that fiscal space has been shrinking in most OECD countries, putting more pressure on social spending as governments reduce budget deficits. Regarding this process Hungary is

the only exception where fiscal consolidation was accompanied with decreasing social spending (*Figure 3*).

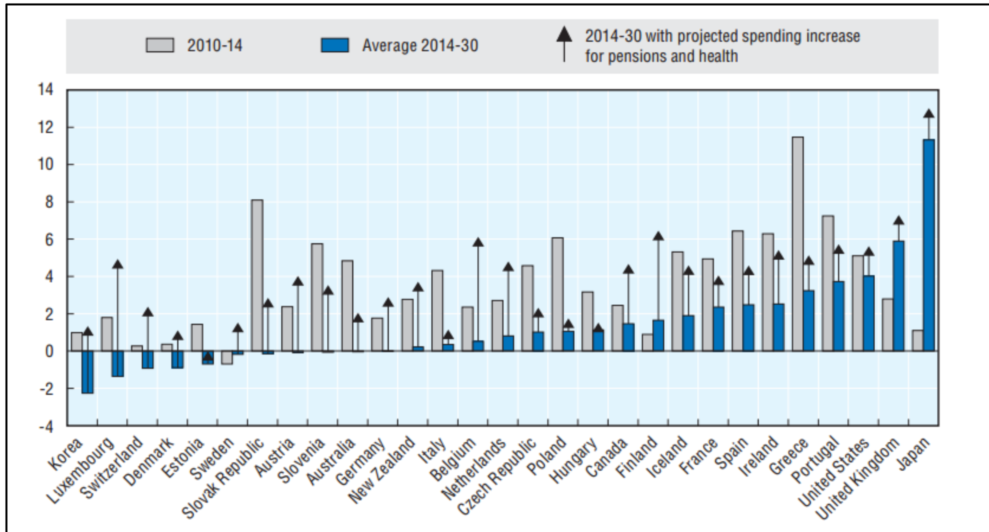
Figure 3: Relationship between consolidation efforts and change in social expenditure



Source: OECD (2014) pp. 41.

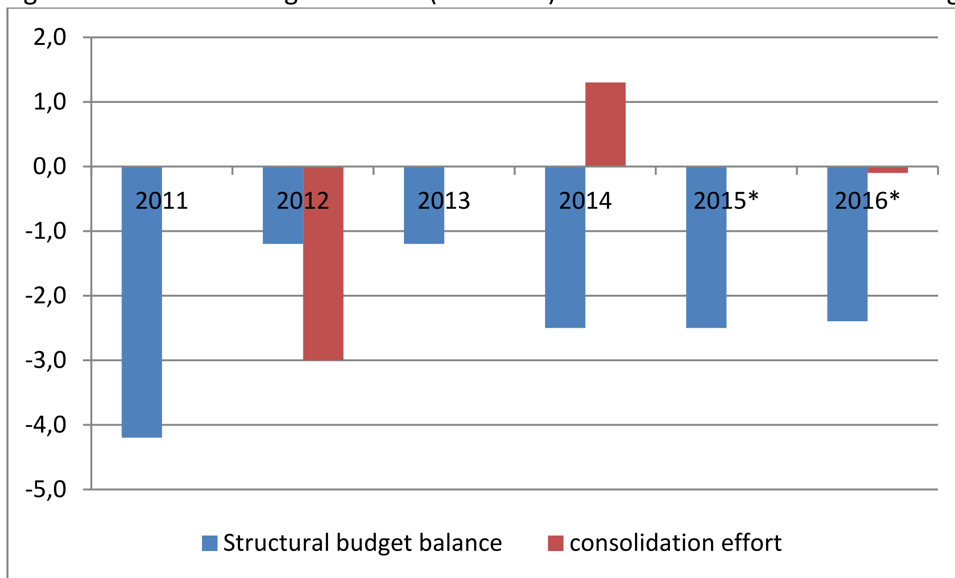
Analysing short and long term consolidation efforts, it can be concluded that Hungary already carried out significant consolidation efforts between 2010 and 2014, and the long term projections are considerably lower.

Figure 4: Short-term consolidation efforts (2010-14) and medium-term consolidation scenarios (2014-30)
Change in the primary budget balance, in percentage of GDP



Source: OECD (2014) pp. 42.

Figure 5: Structural budget balance (% of GDP) and consolidation effort for Hungary



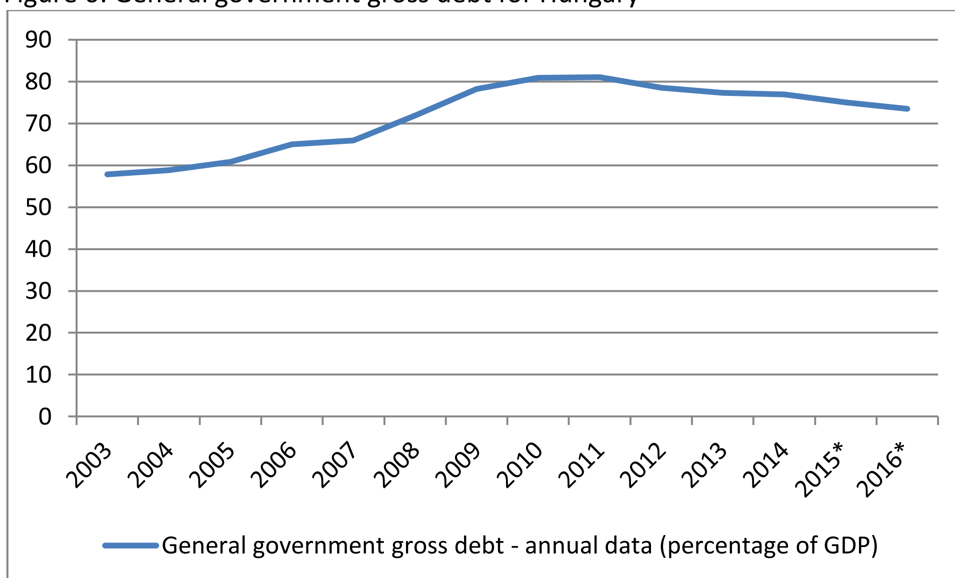
Source: EC (2015b)

Note: Consolidation effort is calculated by the change in structural balance.

Public debt: Hungary is one of the worst-hit countries of the current financial crisis among the East Central European (ECE) countries. Financing external debt became a major constraint on policy in Hungary; in October 2008 the country received external financing from the IMF and EU under terms that implied budgetary restriction.

The high level of public debt in Hungary was an exception within the ECE, while in general the region was characterised by low debt levels in international terms. 2008 can be treated as a turning point in indebtedness processes of the region, debt levels started to rise considerably.

Figure 6: General government gross debt for Hungary



Source: Eurostat, forecasts (*) based on European Commission Spring 2015 Economic Forecast: Tailwinds support the recovery

In 2003 general government gross debt level was slightly below 60 per cent of GDP, and afterwards it started to increase significantly. Debt level before the outbreak of the crisis was 71.9 per cent of GDP, and gross domestic product shrunk by 7 per cent in 2009. Since recovery in Hungary was considerably modest, debt level exceeded 80 per cent of the GDP in 2010 and could have been slightly reduced only after 2012.

Hungary is currently in the preventive arm of the Stability and Growth Pact and subject to the transitional debt rule for 2013-2015. According to the Convergence Programme, the government plans to gradually reduce the debt-to-GDP ratio to 74.9% in 2015 and to 68.9% in 2018. The macroeconomic scenario underpinning these budgetary projections is broadly plausible until 2016 and becomes favourable thereafter (EC, 2015b).

Current challenges: Hungary appears not to face a risk of fiscal stress in the short term. Risks to fiscal sustainability are low also in the medium and long term perspective, conditional upon the full implementation of the planned ambitious fiscal consolidation and on maintaining the primary balance well beyond 2014 at the level expected to be reached in that year (EC, 2015b). After several considerable consolidation efforts government debt is still above the 60% of GDP Treaty threshold and expected to remain above the threshold for long. The focus should, therefore, be on reducing government debt.

Beside fiscal consolidation results it has to be noted that poverty is the most severe in Hungary beside Bulgaria and Romania where more than one-quarter of the population is severely materially deprived. However, the trend of poverty has been declining in Bulgaria and Romania but increasing in Hungary (Darvas – Tschekassin, 2015).

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ANALYSIS 3: Public finance consolidation in Poland

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This paper offers an overview of the public finance consolidation in Poland between 2009 and 2015. Motivation to scrutinise developments in public finance consolidation arose from conclusions that the ongoing economic crisis eroded fiscal stability and might hamper economic growth. Thus, the struggle with budget deficits appearing in each of the V4 (Visegrad) countries, particularly in Poland, requires assessment. The necessity of fiscal consolidation comes from two legal sources: the first is the EU's corrective arm of the Stability and Growth Pact – Excessive Deficit Procedure – which started in 2009; the second is the fiscal brake implemented in the Polish constitution.

The overview of the fiscal situation in Poland: As in the other V4 states, Poland's budgetary situation worsened significantly in 2009 as a result of the global economic crisis, leading to the European Commission's decision to start the Excessive Deficit Procedure[2] (only a year after the closure of the previous EDP, started in 12 May 2004 and then introduced by the European Council).[3] The interesting fact was that, contrary to the other V4 countries, the deterioration of the fiscal situation in Poland in 2009 was accompanied by positive (but much weakened) economic growth.

The Commission gave the Polish government three years (by 2012) to repair the excessive deficit, which meant that Poland needed to prove a fiscal effort of 1.25 percentage points annually and bring the deficit down to below 3% of GDP. Despite the Commission's positive assessment in 2012,[4] in 2013, due to worsening external conditions the EDP, the program in Poland was maintained, with an updated deadline of 2014. At the end of 2013, the Council decided to extend the goal of reducing the deficit to under 3% of GDP to 2015.[5] In May 2015, the Commission – by estimating that Poland's efforts to decrease the deficit under 3% of GDP were effective – ended the procedure.[6]

2 SEC(2009) 864, Brussels 24.06.2009; Council Decision of July 2009 on the existence of an excessive deficit in Poland (2009/598/EC).

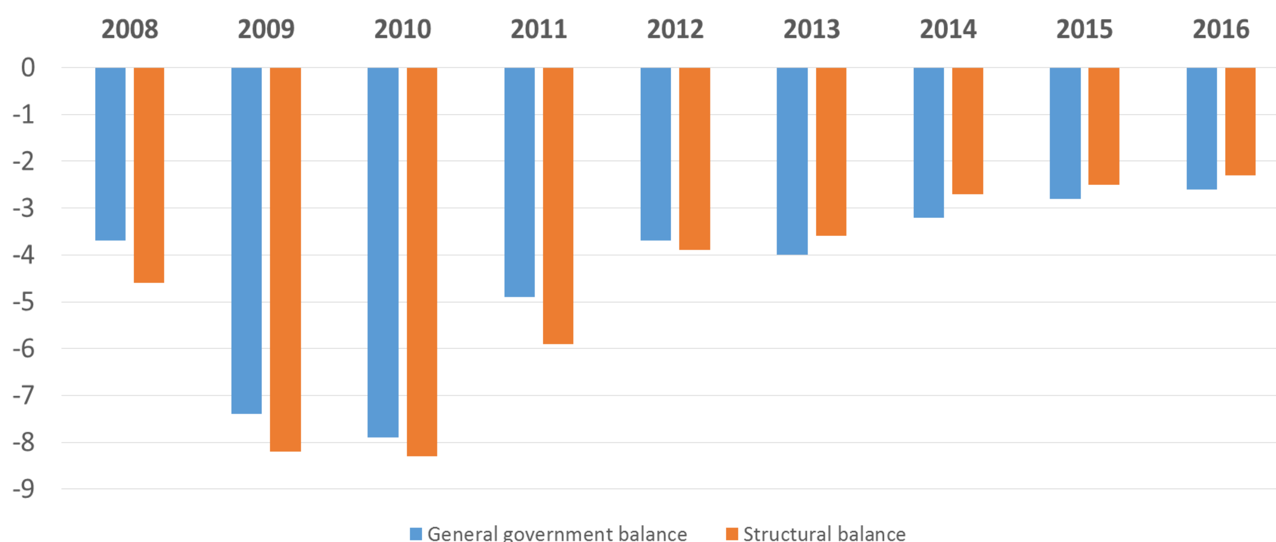
3 SEC(2004) 828, Brussels 24.06.2004; Council Decision of 5 July 2004 on the existence of an excessive deficit in Poland (2005/183/EC).

4 COM(2012) 4, Brussels 11.01.2012.

5 COM(2013) 393, Brussels 29.05.2013; Council Decision of 10 December 2013 establishing that no effective action has been taken by Poland in response to the Council Recommendation of 21 June 2013 (2013/758/EU).

6 COM(2015) 243, Brussels 13.05.2015.

Graph 1: Fiscal balance in Poland in 2008–2016 (% GDP)



Source: Spring Economic Forecast 2009, DG ECFIN, Brussels; Spring Economic Forecast 2015, DG ECFIN, Brussels.

The global economic crisis affected even the fiscal stability of Poland. The general government balance deteriorated from around 3.5% of GDP, in 2008, to 7.5%, in 2009, (Graph 1). It was caused by the drastic decrease of revenues with stable expenses. A slightly more negative balance occurred in 2010, as the structure of the expenses was not timely adjusted to the economic conditions of the new crisis. The structural deficit (which is independent from the business cycle and one-off measures), during 2009–2010, exceeded even 8% of GDP.

The first effects of the fiscal consolidation were visible in 2011, when both types of debt decreased: the general government balance fell to 4.9%, while the structural deficit dropped to 5.9%. In 2012 and 2013, the deficits did not exceed 4% of GDP, but they still failed to reach the EDP goal of 3% of GDP.

Graph 2: The public debt in Poland in 2008–2016 (% GDP)

Source: Spring Economic Forecast 2009, DG ECFIN, Brussels; Spring Economic Forecast 2015, DG ECFIN, Brussels.

The public debt grew sharply from 46.6% of GDP, in 2008, to 49.9% of GDP, in 2009, and continued to rise in 2010, when it reached 53.6% of GDP. In 2011, the debt growth pace decelerated, and the debt level amounted to 54.8% of GDP. In 2012, the first effects of fiscal consolidation were visible in terms of public debt – Poland noted its first debt decrease since the beginning of the crisis to 54.4% of GDP. The debt, however was still unsustainable, and grew in 2013 to 55.7% of GDP. In 2014, the debt decreased to around 50% of GDP. The projections for 2015 and 2016 foretell a slight increase, to near 51% of GDP.

The conditions of fiscal consolidation: The pre-consolidation situation in Poland was relatively difficult and determined the design of the strategy to decrease the excessive deficit. The biggest constraint to cut deficit was the considerable inflexibility of public expenses. In 2009, around 72% of public expenses were fixed – most of them were determined by other regulations than the budget law, including the pension system, subsidies to the local administration authorities, and military spending, broadly regulated in the act on reforming Poland's army. Other fixed spending were the planned public debt repayments, the contribution to the EU budget and the contributions to international institutions. Another problem was the fact that the government had little influence on the fiscal situation of the local administration units, thus limiting the consolidation efforts to the government level.[7]

The other important factor affecting consolidation design was the inflow of EU budget allocations to Poland, which required co-financing from the Polish beneficiaries of these funds. In a considerable part of these funds, the local administration units were spending this EU capital, and the co-financing caused their heavy indebtedness, thus further limiting the government consolidation effort on the local level.

The EU budget also had an important impact on consolidation design. Because Poland wanted to prove it could spend EU money and thus maintain a fast development pace, the national investment plans in infrastructure assuming a huge allocation from the EU budget could not become a target for a consolidation. The conditions of public finance consolidation clearly showed that the most straightforward way to reduce a deficit is in the revenues, not in the expenses.

The consolidation effort – expenses in 2010–2014: The consolidation effort could be done on the revenue side as well as the expenses side. A total consolidation effort in 2010–2014 in both amounted to 3.3 percentage points of GDP.[8]

Regarding expenses: the government adopted a comprehensive set of measures. The earliest ones included the modification of fiscal rules for local administration units. The new regulation (Art. 242 of the Public Finances Act), in 2011, introduced a new rule concerning the balanced budget for local units, changed in 2013 into individual debt limits rule, based on the 3-year moving average of the debt value.

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7 Gajewski P., Skiba L., *Problemy polityki fiskalnej w Polsce na drodze do strefy euro w kontekście uwarunkowań i doświadczeń innych państw*, Narodowy Bank Polski, Warsaw, November 2010.

8 Rada Ministrów, *Wieloletni Plan Finansowy Państwa na lata 2015–2018*, Warsaw, April 2015.

The new rule included some exceptions to exclude from the debt in order to maintain the absorption rate of the structural funds.[9]

In 2011, the government introduced a new rule limiting the pace of growth of discretionary and fixed expenses by 1% a year. That same year, the government froze remunerations in public administration, with exceptions for teachers, university staff, judges, public prosecutors, firemen, Government Protection Bureau, border and prison guards.[10]

The other important group of tuned expenses is linked with the pension and social security system. Since 2009, the entitlements for early retirements were limited. But, an even more crucial change was the extension of the retirement age from 62 to 67 years for women and from 65 to 67 years for men. Funerary benefit was reduced to 4,000 PLN, and a new income criterion was introduced regarding the one-off childbirth benefit ("becikowe"), which amounted to 1,000 PLN. The government limited access to sickness benefits for soldiers and other government services, judges and public prosecutors.[11]

The consolidation effort – revenues in 2010–2014: The reforms on the revenue side had a moderate effect (0.7 percentage points in 2010–2014) due to weakening domestic demand. But certainly without these changes, the revenues would shrink excessively.

Starting in 2009, the government froze the PIT thresholds (18%/32%) in nominal terms. This also applied to tax free earnings in Poland, currently amounting to around 736€ a year. Additionally, the government increased the disability contribution paid by the employers by 2 percentage points. The child tax reliefs and tax Internet relief were limited.[12] The government also limited the possibility to deduct 50% of revenue of authors producing intellectual or artistic products from their taxable income.

Regarding the VAT, in 2011, the government temporarily changed the rates: a reduced rate from 3% to 5% for food, books, and press; a reduced rate from 7% to 8% (i.e., for construction services)[13], and a regular rate from 22% to 23%. In order to prevent the negative impact on the poorer citizens, the government moved food from a 7% reduced rate to a 5% reduced rate.[14]

The government put efforts on the tax base, broadening and simplifying the taxation. This included a limitation of tax deduction for things such as buying trucks and fuel designed for them. The government also introduced a solidary responsibility in VAT of the buyer for tax liabilities of those selling steel and steel products, fuels or unprocessed gold.

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9 Ibidem.

10 Ibidem.

11 Ibidem.

12 Ibidem.

13 A full list of items taxed with a reduced 7% (and afterwards 8%) rate is available here: http://aktyprawne.poznajpodatki.pl/wp-content/uploads/2013/04/vat_2012_zal_3.pdf (in Polish) (Accessed 18.05.2015). Please note, that food products are transferred to the 5% reduced VAT rate, which is not included in this document.

14 Rada Ministrów, *Wieloletni Plan…,* op. cit.

The excise duty for oil, fuel and cigarettes was increased. The government introduced a tax on natural resources (copper and silver since 2012) and an auction system for CO2 emission allowances. The fees for road usage through the ETC system were increased.

Another important change was the transfer of specific assets (mainly public debt securities) from the private obligatory pension funds to the public one.[15]

A fiscal brake: Poland's public finances are constrained by a debt brake, which is written into the Polish constitution (Art. 215, section 5). The goal of the debt brake is to limit the debt-to-GDP ratio to 60%, maximum. The design of the fiscal brake foresees a few precautionary thresholds. The first, set at 50% of GDP, introduces a rule that the deficit-to-revenues ratio cannot exceed the corresponding ratio in the previous year. This threshold has been suspended since 2013.

A next threshold, at the level of 55% of GDP, foresees a set of precautionary activities: the next budget project should exclude the government deficit or it should assure the decrease of public debt; it freezes the remunerations in public administration; it limits raises in pension payments; it precludes the budget lending to any other units; it freezes the expenditures of the crucial government units („Kancelaria Sejmu i Senatu", Supreme Court etc.); it limits the expenditures of the local authorities. The government is obliged to review the expenditures and propose a recovery plan.

The final 60% of GDP threshold assumes similar activities as the 55% of GDP threshold, but it also includes such government obligations as presentation of a recovery plan within one month of the announcement of the excessive debt level. The local administration cannot spend more than it obtains in a particular year and it cannot grant guarantees.

Hidden debts: Hidden debts, in general, refer to the financial liabilities owed to the future payments in the pension system. According to FOR, it includes liabilities to ZUS (public pension system), and, in 2013, amounted to around 3 trillion PLN and it was around 195% of GDP.[16] It also covers such items as the National Road Fund, which noted deficit in the previous years around PLN 2 bn,[17] but its liabilities amounted to totally around PLN 45 bn.[18] Although it is included in a debt count while using ESA 95 and 2010 methodology, still the national methodology used for debt brake does not include it and thus the obligatory measures to limit a debt were triggered later.

Some NGOs (i.e. Fundacja Republikańska) pointed the problem of externalizing the debt at the local level from the local administrative units to the special purpose vehicles, which do not count to the overall public debt.[19] The government imposed on the local authorities a debt constraint of 60% of their yearly incomes. While the local units were obliged to spend money for fixed specific activities (i.e. investment,

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[15] Ibidem.

[16] http://www.dlugpubliczny.org.pl/pl/metoda-liczenia (Accessed 18.05.2015).

[17] Report on Activities of Bank Gospodarstwa Krajowego in 2014, http://www.bgk.com.pl/annual-report

[18] http://biznes.gazetaprawna.pl/artykuly/729038,solska-szybciej-sie-zadluzamy-niz-rozwijamy-dlug-nas-dusi.html (Accessed 18.05.2015).

[19] Horała M., *Jak ukryć dług w gminie?*, Centrum Analiz Fundacji Republikańskiej, Warszawa 2011, http://cafr.pl/jak-ukryc-dlug-w-gminie/# (Accessed 18.05.2015).

health care etc.), they needed to gather means and avoid the official restrictions. The creation of new corporations which can borrow money from the market and simultaneously which operations did not burden the local budgets was a relatively popular solution.

Public opinion's audit on public finances: There is moderate awareness of the public finance issue in Poland. It should be stronger, as the data show a correlation between a perception of debt as a problem and debt level: the bigger the awareness the lower debt.[20]

In Poland, there are some grassroots initiatives regarding the improvement of public debt awareness. The first one is debt counter, initiated in 2010 and maintained by FOR (Forum Obywatelskiego Rozwoju). The counter is available online, at www.dlugpubliczny.org.pl; physically, it is visible in the centre of Warsaw in a few venues with the biggest traffic (to widely target public opinion). The counter provides a few figures: the official and hidden Polish debt, the official and hidden debt as a percentage of GDP, and the official and hidden debt per capita.

FOR estimates that the public outreach informs up to 6 million citizens a month. The functioning of this debt counter is discussed and promoted in the media (TV, radio, media portals, newspapers – even in the frontline). Based on the initial success of the debt counter, FOR launched an information campaign on the negative effects of the excessive debt.

The second interesting project that aims at raising public finance awareness is the map of the expenses prepared by the Fundacja Republikańska. The organisation evaluates the budget of the state and presents a comprehensive infographic where the public money is spent.[21] The project was launched in 2011. The organisation also started to develop a project and introduced the similar maps for the biggest municipalities. The reach of this project is, however, less ambitious than the debt counter.

Challenges: In May 2015, the Commission ended the EDP in Poland, which, on one hand, is positive information. On the other hand, it raises concerns about further public finance consolidation, especially when 2015 is a year of double elections – presidential and parliamentary. Regardless of the winning party, a relaxation in fiscal policy is highly possible, which could trigger a new EDP.

Still, a substantial part of Polish public expenses are fixed. The government should reduce this share to better accommodate the external shocks requiring sharp cuts in spending on the national and local level. It is also important to distinguish between what is to be cut and retained. One of the greatest concerns in Poland is the unemployment rate, which should be included in the design of future fiscal consolidation. The same applies to revenue side of consolidation – if some new items are necessary to introduce, they should not hamper the economic growth and employment.

[20] Golias P., *Public consolidation in Slovakia*, INEKO, 2015.
[21] http://www.mapawydatkow.pl/ (Accessed 18.05.2015).

ANALYSIS 4: Public finance consolidation in the Czech Republic

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May 2015

Introduction: The Czech Republic has been established 1993. Institutional environment and peoples' way on looking at life were intensively distorted by the large heritage of communism. Unsurprisingly, this was also problem for the public sector because the Czech public finance got a massive shock on both revenue side and expenditure side, chiefly the latter, of course.

After the transition period and establishing of new public institutions, new regulators and dream careers of some new bureaucrats, a development of the Czech public finance has got the standard direction: every year, a gap between expenditures and revenues generated a new deficit. And cumulating of red numbers means nothing but public debt.

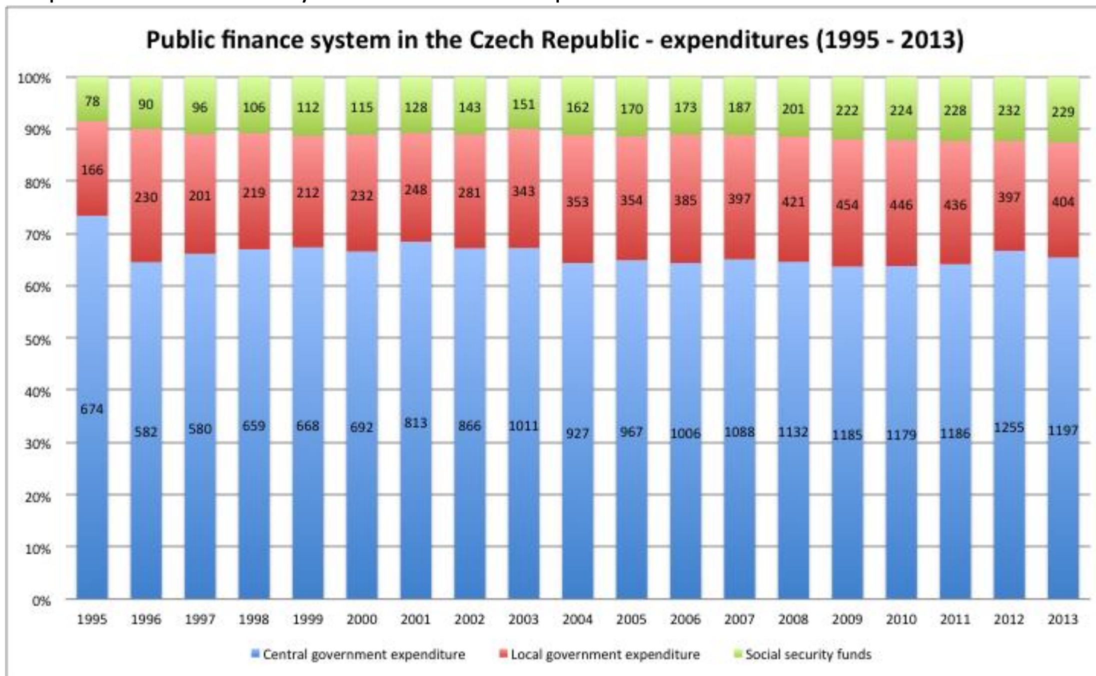
A rapid increase of debt per head and debt related to GDP caused a demand for a consolidation of the public finance. However, this has not come yet. Weak governments have not found enough courage to explain to voters that turning the wheel and the rapid cut to the public sector is really necessary, although academicians and economists presented several proposals how to do it. No response.

This paper deals with the issue of public finance in the Czech Republic – how it operates, what is the development of key measures and indicators – and the paper also presents a proposal how to consolidate public finance. Recommendations for decision-makers conclude the paper.

Public finance system in the Czech Republic: The public finance system in the Czech Republic is significantly centralized. The system consists of state budget (central government institutions) and budgets of local governments and municipalities, social security funds and extra budgetary funds. All transactions together are reported as the general government budget. The majority of public resources are redistributed through central government institutions. As usual in other countries, the budgetary legislation is prepared in advance for the next year, spilling over into future years (binding). The state budget, effective under the applicable law passed by the Parliament, consists of chapters; these chapters follow the economy of individual institutions (e.g. office of the President, Parliament, ministries, bureaus, etc.). Local governments and city councils are responsible for own municipal budgets.

The graph number one shows the system from the perspective of expenditures; the volume of central government expenditures fluctuates between 60 % and 70 %.

Graph 1: Public finance system in the Czech republic

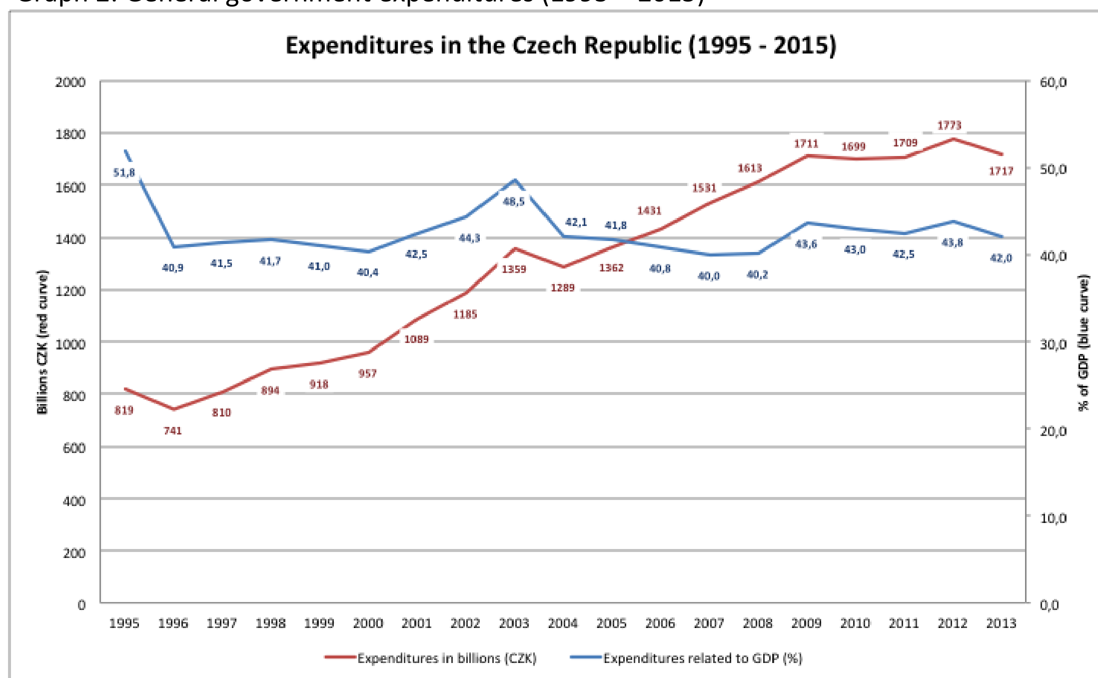


Note: The Y-axis shows a percentage on total expenditures. Numbers in columns show expenditures in billions CZK. Data source: Ministry of Finance, Czech Republic.

Expenditures, revenues, deficits and debt: Let's have a look on a development of the Czech public finance and its actual shape, as well as on international comparisons. For better interpretation, relative numbers (GDP ratios) are used.

Looking at expenditures, the general government expenditures averagely rose by 4 % (annual change) between 1995 and 2013, while the absolute volume increased more than twice to the level 1,700 billion CZK (over 62 billion EUR). According to the GDP ratio, we can safely say that the level of expenditures settled down between 40 and 45 % of GDP after the post-revolutionary shock (in the graph, the shock is visible from 1995).

Graph 2: General government expenditures (1995 – 2015)



Data source: Ministry of Finance, Czech Republic.

According to the international comparison, the level of public expenditures in the Czech Republic is rather low – values are below the average of both European Union and Euro Area countries. The Czech Republic – with the average value at 42 % of GDP – reports the second best result behind Slovakia among V4 countries. Moreover, aggregated outlays for the compensation of general government employees are the lowest ones among compared countries. However, the ratio of mandatory expenditures on total general government expenditures is stable and very high, which lowers a possibility of the Czech public finance to react on macroeconomic shocks.

Table 1: International comparison – public expenditures (2006 – 2014)

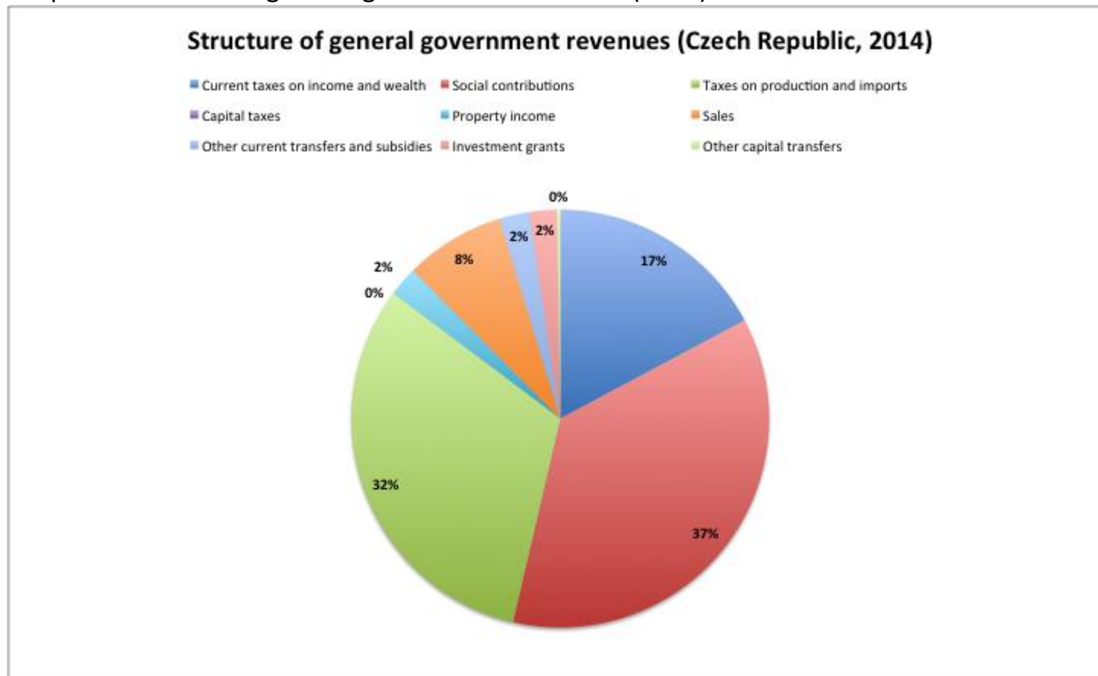
Public expenditures / GDP	2006	2007	2008	2009	2010	2011	2012	2013	2014
EU28	45,6	44,9	46,5	50,3	50,0	48,5	49,0	48,6	48,1
EA	46,0	45,3	46,5	50,6	50,5	49,0	49,6	49,5	49,1
Czech Republic	40,8	40,0	40,2	43,6	43,0	42,4	43,8	41,9	42,0
Germany	44,6	42,7	43,5	47,4	47,2	44,6	44,2	44,3	43,9
Hungary	51,9	50,2	48,9	50,8	49,8	49,9	48,7	49,8	50,1
Poland	44,7	43,1	44,4	45,2	45,9	43,9	42,9	42,2	41,8
Slovakia	38,5	36,1	36,7	43,8	42,0	40,6	40,2	41,0	41,8

Note: ESA methodology. Data source: Eurostat.

The structure of general government revenues of the Czech Republic is displayed in the graph number 3. The highest volume of revenues (37 %) is generated by social contributions paid by both employers and employees. Taxes on production (esp. VAT and excise duties) create 32 % of revenues, while income

taxes generate just 17 % of all revenues. The level of social contributions receivable is significantly higher in the Czech Republic than in other V4 countries.

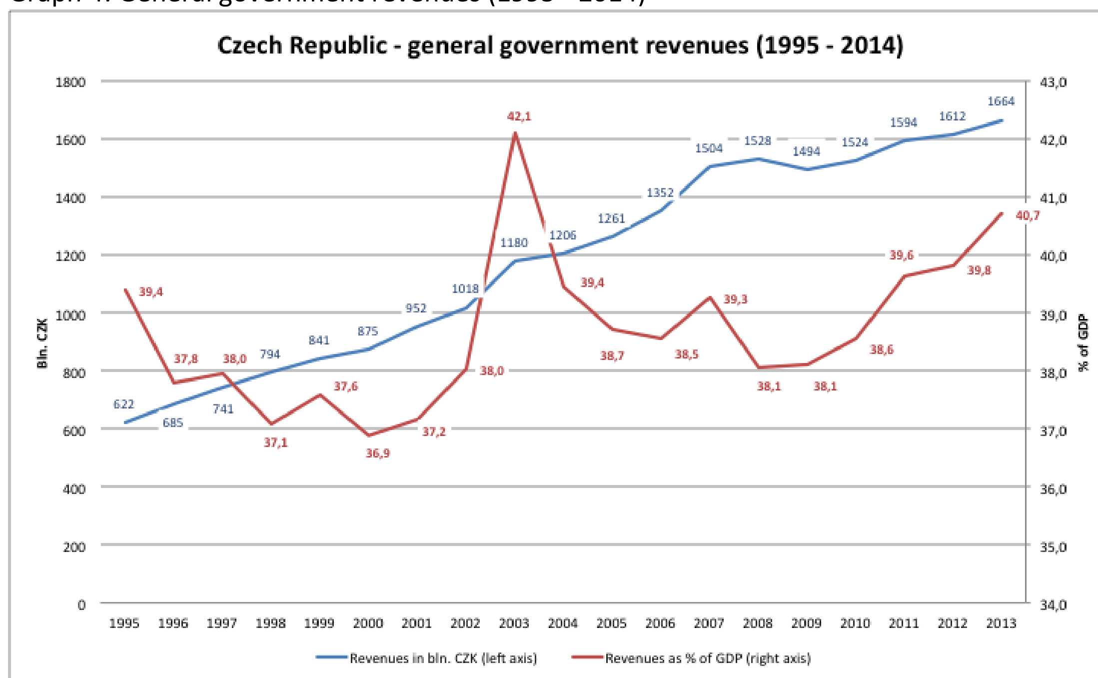
Graph 3: Structure of general government revenues (2014)



Data source: Ministry of Finance, Czech Republic.

The graph number 4 shows a development of general government revenues between 1995 and 2014. The volume of public revenues rose very significantly (+5.7 % annually) as well as a trend of the revenues/GDP ratio. Fluctuations – especially in 2003 – are caused by economic cycle. As mentioned before, a high proportion of social contributions as a principal factor of taxation of labor is critically discussed quite often, however, no government has found political courage to change the tax system. The system is – obviously – too complicated, with thousands of pages of legislation, tax exceptions, progressive (income tax) and regressive (quasi taxes) elements, which negatively influences ability to control tax liabilities and to collect prescribed taxes as well.

Graph 4: General government revenues (1995 - 2014)



Data source: Ministry of Finance, Czech Republic.

The table number 2 shows the international comparison of V4 countries plus Germany and averages of both European Union and Euro Area. All V4 countries, except of Hungary, hold the relative level of revenues below the EU and EA averages. The Czech Republic – again – reports the second lowest numbers; from the perspective of general government revenues on GDP, Slovakia has the minimal state.

Table 2: International comparison – public revenues

Revenues / GDP	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**
EU28	44,0	44,0	44,0	43,6	43,6	44,0	44,7	45,4	45,2
EA	44,6	44,7	44,4	44,4	44,3	44,9	46,0	46,6	46,7
Czech Republic	38,5	39,3	38,1	38,1	38,6	39,7	39,9	40,8	40,1
Germany	43,0	43,1	43,5	44,4	43,1	43,7	44,3	44,5	44,6
Hungary	42,5	45,2	45,3	46,2	45,2	44,4	46,4	47,3	47,6
Poland	41,1	41,2	40,8	37,9	38,2	39,0	39,2	38,2	38,6
Slovakia	34,9	34,1	34,3	35,9	34,5	36,4	36,0	38,4	38,9

Note: ESA methodology. Data source: Eurostat.

It is clear that expenditures higher than revenues mean nothing but negative deficit, i.e. the increase in public debt. Before 1995 and 2014, no V4 country reported net lending in the public finance in any of analyzed years. The total average of annual net borrowing of general government for V4 countries within the time period is -4,7 % of GDP; Czech Republic and Poland are below the average. The table number 3 shows the development of public debt and with respect to the information above it is not really surprising. The public debt of the Czech Republic has risen rapidly in past 10 years (+14,4 p.p.), although

the level of indebtedness is the lowest one from analyzed countries. Hungary has to deal with the highest debt – it reached almost 77 % of GDP in 2014.

Table 3: International comparison – general government gross debt (% GDP)

Debt / GDP	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Czech Republic	28,5	28,0	27,9	27,8	28,7	34,1	38,2	39,9	44,6	45,0	42,6
Hungary	58,8	60,8	65,0	65,9	71,9	78,2	80,9	81,0	78,5	77,3	76,9
Poland	45,3	46,7	47,1	44,2	46,6	49,8	53,6	54,8	54,4	55,7	50,1
Slovakia	40,6	33,8	30,7	29,8	28,2	36,0	40,9	43,4	52,1	54,6	53,6

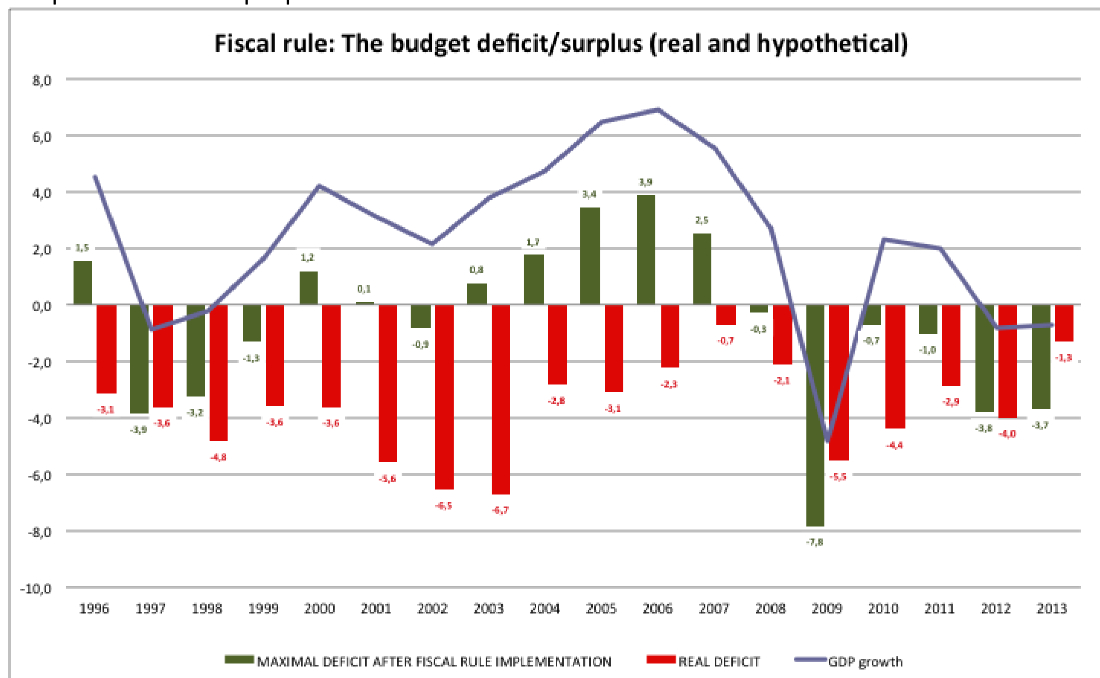
Note: ESA methodology. Data source: Eurostat.

Consolidation: As far as the real consolidation of public finance has not been implemented yet in the Czech Republic, this chapter could be the shortest one. To avoid it, I am going to share some experiences of the National Economic Council and its proposal on this issue.

During last 20 years, many politicians, economists, journalists and others debated, lectured or wrote about a necessity of public finance consolidation. Due to the high relation of mandatory expenditures (i.e. expenditures guaranteed by legislation), a way through consolidation of significant expenditure chapters of public budget seemed to be the best possible choice. Nevertheless, there has been no long-term and meaningful reform in areas like bureaucracy and administration of public sector, health system and education, police, army, or pension system. The pension system, for example, was reformed in 2013 by implementation of the 2nd pension pillar, but the then governmental opposition immediately discredited it and announced its cancelation after elections. Therefore, a very low interest to participate had been registered. And, the cancellation of the reform was truly agreed during the last year. All attempts to consolidate "shipwrecked" on weak governments and "unsuitable" economic conditions. Fiscal adjustments have been limited to non-complex policies like accounting tricks (binding for budget planning) or one-shot expenditure cuts, followed by "Peltzman effects" and successive increase of expenditures to the same (or higher) level.

It was clear and it is clear that politicians, suffering from information asymmetry in comparison with bureaucrats, are not able to lower the public finance intervention spontaneously. That is why the National Economic Council, advisory body to the Czech Government, proposed an implementation of an automatic stabilizer of public finance – the fiscal rule. The rule should respect the "Keynesian" idea of fiscal surpluses during economic booming and possible fiscal deficits during economic downturns. According to the proposal, the budget should be planned with respect to the maximal gap between growth of real GDP and the deficit of public finance at the level 3 percentage points [GDP (%) – deficit (%) = 3 p.p.]. The prognosis of GDP would follow a colloquium of distinguished institutions from public sector (ministries, national bank…), private sector (banks, consultant firms) and academia (universities), both domestic one and foreign one.

Graph 5: Fiscal rule proposal



Data source: Ministry of Finance and the Czech Statistical Office, Czech Republic.

On the graph above, there is a GDP growth (dark curve) and the real deficit of the Czech public finance (red columns). Especially between 2002 and 2007, the fiscal policy was not respecting the economic cycle. The implementation of proposed fiscal rule would lead to the green reality, i.e. to surpluses during upturn of the Czech economy. The fact is that the rule, no matter if this one or modified one, would tide hands of politicians and their bureaucrats and secure that the fiscal performance would not break away from economic performance. Unfortunately, the proposal has been rejected during negotiations with the government and the ministry of finance.

Conclusion: The recent government of the Czech Republic, led by the Prime Minister Bohuslav Sobotka (social democrat), declared that after years of “fiscal starvation”, the economy must get a significant impulse in the form of public expenditures, public investments and higher number of public procurements. However, the brief fiscal outlook above shows there is no fiscal starvation. Contrariwise, public expenditures rise, the gap between revenues and expenditures is still in red numbers, which means cumulating of deficits.

Without the real consolidation of public finance, no improvement of the recent situation is possible. But, in the environment of rationally ignorant voters, weak politicians and very strong bureaucrats (maximizing their utility by maximizing budgets of their bureaus), the only way how to consolidate public finance in the Czech Republic is a powerful legislative norm, which bans spontaneous enlargement of public finance, i.e. of public sector. After that, particular reforms of pension system, education or health system will not be just possible, but essential.

Data sources: Czech Statistical Bureau, Eurostat, Ministry of Finance of the Czech Republic

ANALYSIS 5: Budget consolidation in Ukraine

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Introduction: Budget consolidation is a very important issue for Ukraine. After events such as the toppling of Ukrainian president Viktor Yanukovych following the Revolution of Dignity, the annexation of Crimea and a subsequent military confrontation with Russia, the Ukrainian economy found itself in an extremely difficult condition. It should be taken into account that before the aforementioned factors came into play, Ukraine had already been experiencing grave problems, such as economic stagnation dragging on since 2012, the lack of reforms, pervasive corruption in the executive and judicial branches, an unbalanced external government borrowing policy, etc. These factors had a negative impact on Ukraine´s budget, contributed to a significant increase in the budget deficit and domestic debt as well as worsened the possibility to generate profits and ensure budget revenues.

Despite some progress the Ukrainian government made with regard to its obligations to bring Ukrainian legislation into line with EU laws, the budget legislation in Ukraine has not been reformed thus far. Ukrainian legislation does not provide for budget consolidation in EU terms. However, Ukrainian legislation provides for some measures to be taken to stabilize the budget, ensure sound public finances, reduce budget spending and increase budget revenues. An important aspect of institutional and technical capabilities to consolidate finances is Ukraine's cooperation with the IMF.

In 2014, Ukraine and the IMF signed a Memorandum which provided for gradual implementation of budget consolidation through optimizing budget spending to reduce imbalances as well as reduce the number of government employees, strengthen public trust and facilitate economic growth.

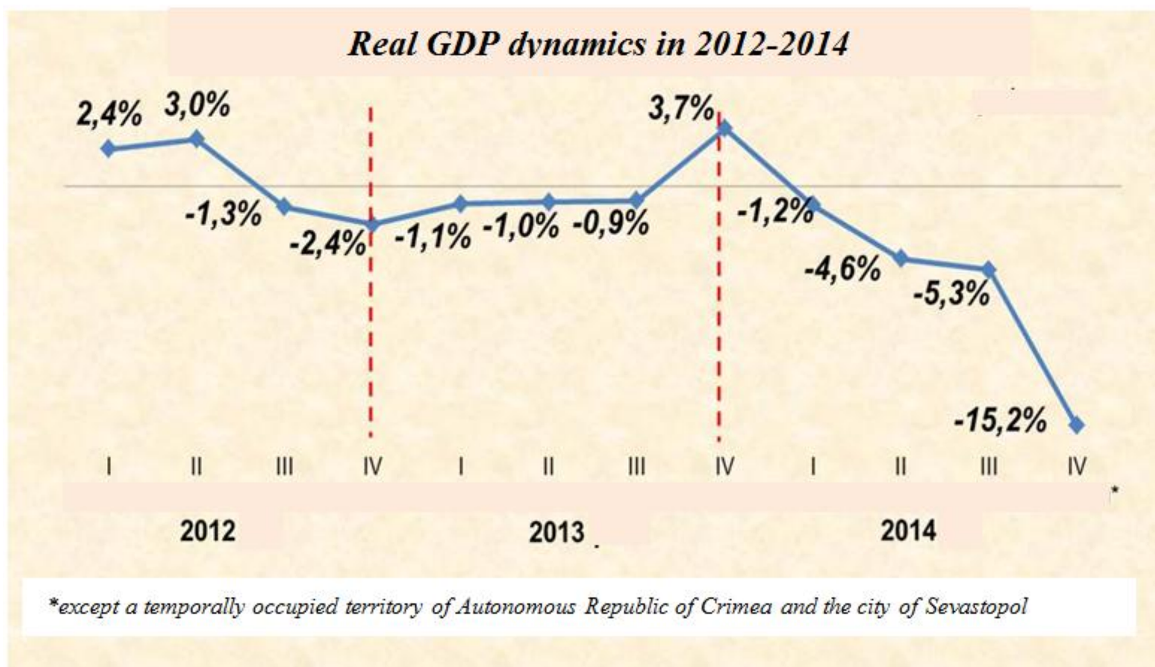
The main economic tendencies: For the past years, the Ukrainian economy has been influenced by a broad spectrum of negative factors, namely the annexation of Crimea, hostilities in Eastern Ukraine, growing public anxiety due to a sharp devaluation of the national currency, rapid inflation, the worsening of the investment climate, a drop in GDP, increased defense expenditures. The aforementioned factors had an adverse impact on the state budget. In addition, as of today, the Ukrainian economy suffers from significant structural imbalances, and is in need of reforms.

The budget and tax policies play a key role in stabilization of the economy. Fiscal consolidation appears, in a way, an anti-crisis strategy for tax and budget policies, which are being implemented within the context of overcoming the effects of the global financial crisis. The implementation of these policies allows for reducing the negative impact of the financial crisis on public finances and improving the general development of the national economy in the long-term perspective.

For Ukraine, the main goal of fiscal consolidation programs is to ensure greater sustainability of public finances (eliminating imbalances in public finances, strengthening state banks, limiting quasi-fiscal operations, improving the financial position of state funds as well as state non-financial corporations).

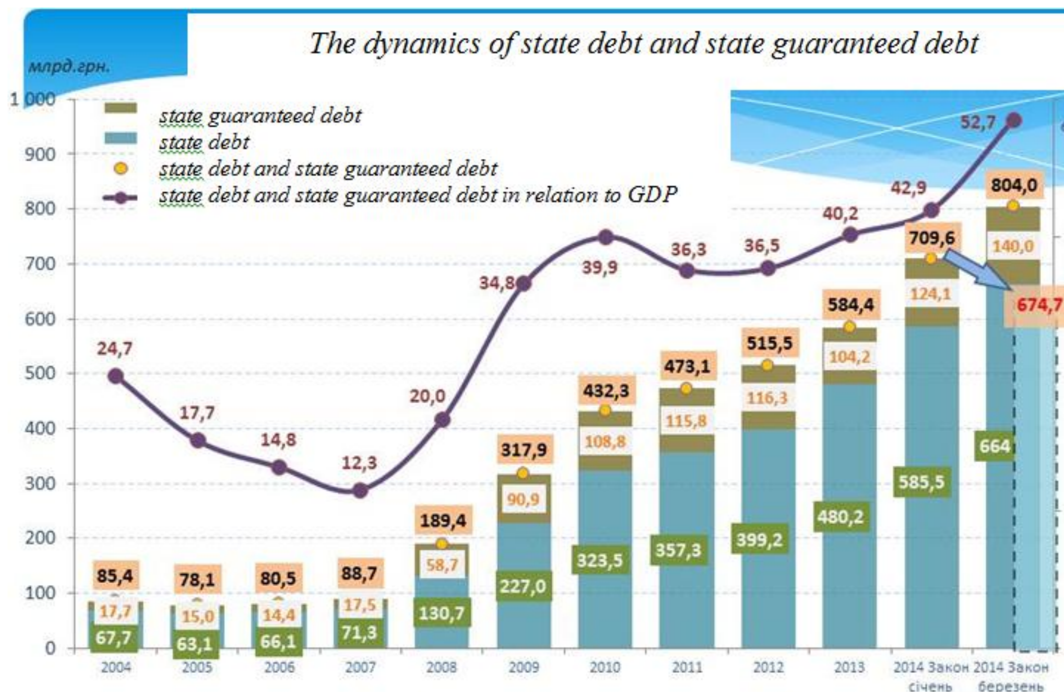
The economic situation reflected in the state budget has been influenced by the following factors:

- hostilities in Donbas, which led to a drop in economic output in the region, the worsening of conditions for external financing, increased budget defense expenditures as well as increased budget spending on the infrastructure damaged or destroyed as a result of hostilities in Donbas;
- the increased debt burden on the state budget due to the necessity to cover the deficit and debts of the national joint-stock company “Naftogaz of Ukraine”, amassed over the past years;
- a significant increase in the deficit of the Pension Fund, which puts an additional burden on the state budget;
- the exhaustion of FX reserves, which makes it difficult for the National Bank to use interventions as instruments for constraining growing public demand for foreign currency caused by public anxiety and speculative attacks.



Beginning in 2012, a fall in industrial output has increased in the current year owing to a suspension of many businesses in the Luhansk and Donetsk regions as well as the loss of access to the Russian market. Ukraine’s dependence on energy imports and the absence of alternative energy sources to the Russian gas will make enterprises introduce tough austerity measures, which will have a great impact on the volume of industrial production.

Problems with the execution of state obligations make the Ukrainian government borrow from internal and external lenders, with public borrowing increasing every year. Beginning from 2011, Ukraine’s state debt and state guaranteed debt increased from 36.3% to 52.7%, according to the database of the Ministry of Finance of Ukraine. However, according to different estimates, these figures do not quite reflect the real situation: in 2014, state debt and state guaranteed debt amounted to more than 62% of GDP.



Ukrainian budget and tax system is characterized by a significant re-distribution through GDP: Under Ukrainian budget legislation, the budget system includes state and local budgets. An aggregate of all budgets (the total number of budgets in Ukraine is more than 12 000) comprising the budget system makes the consolidated budget. The consolidated budget is used for the state regulation of the economic and social development.

The major sources of budget revenues are as follows:

- value added tax charged on goods and services made and provided in Ukraine;
- value added tax charged on imported goods and services;
- corporate tax;
- excise tax;
- rent on subsoil assets;
- import duty.

In 2014, a share of consolidated budget revenues in GDP amounted to 29.1% (against 29.0 % in 2013), indicating the absence of important changes despite a gradual reduction in corporate tax rates as well as reduction in tax preferences. The excess burden of taxation adversely affects the investment climate in Ukraine in particular and the economic development in general.

In 2014, a share of consolidated budget expenditures in GDP amounted to 33.4 % (in 2013, the figure was 34.5 %), indicating the preservation of a high level of state obligations in connection with social services.

The main problems with the financing of consolidated and state budgets are as follows:

1) Consolidated budget expenditures continue to increase, which resulted from the increase in spending on debt service, including due to the hryvnia depreciation, as well as spending on defense, public order, security and the judiciary. At the same time, spending on wages and social security has reduced.

2) The Pension Fund of Ukraine needs significant contributions from the state budget – budget spending on Pension Fund transfer payments continues to increase. In 2014, the Pension Fund received UAH 75813.9 million, including to cover a Pension Fund deficit to be able to pay pensions worth UAH 14683.2 million, which is 32.5 % (UAH 7080.6 million) less than in the previous year.

3) A share of official transfer payments in local budgets has increased over the last ten years. In 2002, it was 31.2 %, in 2010 - 49.5 %, in 2013 – 52.4 %, and in 2014 – 56.4 %, indicating increasing budget centralization and inability of local authorities to ensure the independent development of territorial-administrative units.[22]

The state budget deficit increased from 15.5% to 48% during 2010-2014. Taking into account the capitalization of "Naftogaz of Ukraine" PJSC, the budget deficit amounted to more than 10 % of GDP. The financing of "Naftogaz of Ukraine" was done mainly through borrowing. The deficit was financed, to a certain degree, through the issuance of government bonds in the US dollar, which will increase the debt exposure to currency risks. The financing of the budget deficit as well as debt service is a major challenge due to slow reforms and limited access to external borrowing.

The main indicators of revenues, expenditures and budget deficit in percentage terms in relation to GDP are as follows:

Subject Descriptor	2009	2010	2011	2012	2013	2014	*2015*	*2016*	*2017*	*2018*	*2019*
General government revenue	42.298	43.249	42.870	44.457	43.631	42.631	*42.621*	*42.713*	*42.433*	*42.093*	*41.798*
General government total expenditure	48.554	49.004	45.627	48.744	48.449	48.404	*46.556*	*45.428*	*44.538*	*43.614*	*42.980*
General government net lending/borrowing	-6.255	-5.755	-2.757	-4.287	-4.818	-5.773	*-3.934*	*-2.715*	*-2.105*	*-1.521*	*-1.181*
General government structural balance	-2.231	-3.859	-3.154	-4.397	-4.555	-3.490	*-2.324*	*-1.985*	*-1.817*	*-1.521*	*-1.181*
General government primary net lending/borrowing	-5.090	-4.129	-0.791	-2.374	-2.351	-2.362	*0.638*	*2.397*	*2.908*	*3.121*	*3.100*
General government net debt	31.936	38.416	34.455	35.169	38.709	65.327	*71.429*	*69.338*	*64.923*	*57.593*	*49.875*
General government gross debt	35.380	40.505	36.817	37.367	40.939	67.615	*73.417*	*71.130*	*66.414*	*58.932*	*51.083*

[22] The National Institute for Strategic Studies. The analysis of imbalances in the budget sphere and its solution. http://www.niss.gov.ua/articles/1800/

The chart above suggests that during 2008-2014 the level of revenues and expenditures in GDP almost did not change – 42% and 48% respectively. It is planned to reduce these indicators beginning from 2015 owing to the implementation of the Memorandum signed with the IMF, where budget consolidation is one of the key provisions. It also points to the increase in borrowing, with its peak in 2017, which means that state bodies will have to elaborate a strategy for debt management. Unfortunately, as of today, the debt management strategy in Ukraine is not effective, with its objectives and goals not corresponding to the current economic situation.

Under the Budget Code of Ukraine, “The maximum amount of domestic and foreign State debts, debt of the Autonomous Republic of Crimea, and debts of local self-government, and the maximum amounts of guarantees shall be established for each budget period, respectively, by the State Budget Law or budget decisions of local governments. The principal amount of the State debt cannot exceed 60 percent of the annual Gross Domestic Product of Ukraine. If the State debt exceeds the maximum debt amount stipulated under Section 2 of this Article, the Cabinet of Ministers of Ukraine shall undertake measures to reconcile the maximum amount with provisions of this Code.”

In March-April 2013, the Ukrainian government declared its intentions to take specific measures for fiscal consolidation. In fact, the following steps have been taken:

- a decision was taken to reduce non-priority expenditures;
- populist decisions of the previous government, not backed with real financing, have been revised;
- a realistic macro forecast has been made;
- amendments to tax legislation have been introduced, which would allow for additional budget revenues worth UAH 22.5 billion;
- amendments to the budget have been introduced, which decreased revenues by UAH 22.4 billion and expenditures by UAH 25.4 billion based on the realistic macro forecast.

The aforementioned measures allowed for balancing the 2015 budget, but did not solve systemic problems of public finances. Based on the aforementioned concept, the *Strategy for the Development of Public Finance Management was elaborated and subsequently adopted in 2013. According to the Strategy, the main measures regarding budget and tax consolidation are*:

1. The abolishment of tax preferences for individual enterprises and sectors
2. The increase in tax rates for the emission of carbon dioxide
3. The application of the system of taxation of immovable property items according to their value
4. The balancing of interests of controlling bodies and taxpayers
5. The introduction of legal instruments for the execution of the principle of commercial activities (arm’s length principle).

According to the 2014 Public Financial Management Performance Report, the following key measures have been implemented:

- The regime of tax exemption for operations on medicines and medical products supplies, allowed for the production and consumption in Ukraine and included to the State Register of Medicines, have been cancelled;
- Property tax changes - a total area of residential properties instead of residential area have been introduced as a basis for immovable property (other than land plot) tax;
- Preferential taxation of UCITS with the enterprise profit tax have been limited;
- Taxation of income derived from operations with securities and derivatives at a reduced rate (10%) have been abolished;
- Income tax exemption for the hotel businesses, electricity industry enterprises, which produce electricity exclusively from renewable energy sources, have been abolished;
- Activities on timber cutting, industrial wood production (logs, poles), fuelwood production, deforestation for making land suitable for agricultural production were excluded from the list of activities covered by the special tax regime in agriculture, forestry, and fishery;
- Ineffective income tax exemptions which did not lead to the development of relevant industries have been abolished. These includes: biofuel production; extraction and use of gas (methane) of coal deposits; hotel services; light industry; sale of electricity; shipbuilding industry; aircraft construction industry; machinery construction for agriculture; publishing houses and organizations; printing enterprises; housing and communal services, etc.
- Reduction of the number of taxes, their consolidation
- Other measures

Problems:

At the present stage, there are following problems related to the fiscal consolidation:

- structural imbalances in the economy and untimely and ineffective implementation of structural changes;
- inefficient mechanism of taxation of market participants;
- a significant number of unprofitable state enterprises receiving subsidies;
- the budget expenditure structure inadequate to the existing financial possibilities of the state;
- a significant amount of shadow economic activities;
- misuse and inefficient use of public funds;
- inefficiency of finance and credit relations;
- constant increase in public debt

Main solutions:

- Reduction and changes to the structure of public spending;
- Rationalizing and improving the structure of budget crediting of market participants (especially state-owned enterprises and corporations);
- Enlargement of tax base (by limiting privileges or providing them under other conditions; limiting tax evasion);
- Streamlining the structure of subsidies for market participants changing the terms and conditions of their granting use (especially for state-owned enterprises and corporations); reforming energy prices and bringing them in line with the market prices (particularly, gas prices;

it is advisable to spend savings on financing of targeted support activities and credit programs on increasing energy efficiency); limiting subsidies for losses cover; reorganization of subsidizing for agriculture enterprises and enterprises that produce goods or provide services in the non-trading sectors (it is considered that economy stimulating through subsidies is inefficient and distorts pricing);

- Improving (reforming) mechanisms on the provision and use of social transfers (providing them to those whose consumption is lower than the accepted level (e.g. than minimum subsistence level); transition to targeted social protection system);
- Pension system reform (to ensure long-term sustainability of fiscal policy);
- Strengthening the focus of monetary policy on economic growth and budget revenues increase;
- Limiting quasi-fiscal operations (with the huge amount of fiscal operations in the real sector, in particular, “Naftogaz of Ukraine”);
- According to experts, the need for state apparatus reduction is 10-15% in Ukraine. It is advisable to spend part of the savings from the reduction of officials on increasing salaries for key figures in the sector, who will implement reforms;
- Analyzing the practice of fiscal consolidation (intensification of activities to reduce the deficit of the general government sector and limitation of the public and publicly guaranteed debt) in foreign countries.

Cooperation with the IMF: According to Memorandum with IMF, over 2016-2018, it is planned to continue the gradual expenditure-based fiscal consolidation to reduce imbalances, reduce the size of government, strengthen confidence, and facilitate growth.

Expenditure reforms

a. **Parametric pension reform –** the need for a comprehensive pension reform to revamp the overall objectives and design of the pension system. Despite low average pensions, low retirement age, early retirement options and generous occupational retirement conditions make the overall pension spending as a share of GDP is one of the highest in Europe. It is planned to index pensions to prices and lower the threshold for pension benefits’ income tax liability, as well as to unify special pensions’ calculation rules with those of the general system.
b. **Size and efficiency of government –** ensuring more rational size of the budget-paid workforce with the goal of lowering the wage bill to around 9 percent of GDP over the medium term. It is planned to review salary structures to ensure competitive remuneration, especially at the managerial level of the central government. With the help of our international partners, reforms in the health and education sectors aiming to improve outcomes with more efficient use and mix of resources and resulting in budget savings will be designed and implemented.
c. **Healthcare.** Healthcare reform will aim to open up the sector to private financing and gradually move to a medical insurance system. In view of this, it is planned:

    (i) Change the basis of public financing of the secondary healthcare by moving from hospital bed to service-based financing and for primary healthcare from infrastructure-based to capita-based financing.

    (ii) Allow medical facilities to legally generate own revenue.

(iii) Change public procurement regulation to allow purchasing medicines and medical supplies through direct, multi-year procurement involving UN based organizations.

d. **Education.** The reform in education sector, commenced in 2014, aiming to improve the quality and efficiency of education spending, will continue. It is planned to optimize general secondary school system reducing the number of schools by 5 percent by consolidating small schools and reducing employment accordingly; and reducing public appropriation for training specialists depending on the needs of the economy and demographic trends.

e. **Social assistance.** To protect the most vulnerable groups from higher energy bills, it is planned to improve the design of existing social assistance programs (currently comprising of category-based for housing utilities; means-tested subsidies for housing utilities; and a new tariff compensation scheme; the general guaranteed minimum income (GMI) program, as it is better targeted to low-income households, though this will require substantial administrative effort).

f. **Investment.** To support growth, it is planned to increase and maintain capital investment levels, from 1 percent of GDP in 2014 to over 3 percent of GDP by 2018, to fund Ukraine's immediate reconstruction needs and long-term infrastructure development objectives.

Tax policy reforms

g. **Social security contributions.** It is planned to continue reducing the social security contribution wedge, which should help encourage de-shadowing of wage payments. The pace of this reform will be closely linked to progress in reducing pension spending.

h. **Agriculture VAT –** the effect of the general VAT regime for the entire agricultural sector in line with international practice.

i. **Personal income tax –** steps to better detect and tax the income and wealth of high net worth individuals, drawing on technical support from the IMF.

j. **Property taxes –** elimination of exemptions and raising of tax rates. The additional revenue will help strengthen the own revenue base of subnational governments.

k. **Extractive industry taxation –** a new fiscal regime for the extractive industries from 2016 that will make a transition to taxation based on international best practice, including a review of the current level of royalties. It is planned to prepare and submit to parliament the relevant amendments to the tax code by July 1, 2015 and in parallel strengthen administrative capacity in this area, drawing on IMF technical expertise.

Conclusions: In order to achieve fiscal sustainability, a state legislatively defined budget strategy is required. It will ensure the predictability of budget system responses to the challenges and opportunities that may arise in the various versions of the global economic development. It will also provide preventive use of an adequate set of measures under the negative impact of external economic factors. The fiscal consolidation programs are being accepted in Ukraine. However, due to the internal and external challenges, implementation of measures in the context of fiscal consolidation has mainly feebly marked positive effect. During further implementation of fiscal consolidation plans in Ukraine, it is reasonable to take into account the positive and negative experiences in order to improve its socio-economic effectiveness and avoid possible negative impacts.