Fiscal reform: abandoned?

Ask the average exchange dealer, EU bureaucrat or Czech layman what the most pressing problem of the Czech economy is and chances are high that he or she will say it's the public budget, namely the growing deficits. After years of denial, even Czech politicians have grasped the idea and been converted to reform en masse. In word, at least. When it comes to deeds— real policies—politicians suddenly run out of enthusiasm and retreat.

Many analysts, including myself, have been criticizing this paralysis for years and begged for a well-structured and thought-through fiscal plan. Therefore, when an offer to work on such a plan came, it was difficult to refuse it. The new government, formed after the 2002 election, did not exactly boast economic proficiency, but the new finance minister, Bohuslav Sobotka, put together a relatively strong team of "external advisers" and a handful of "standard advisers" and floated some encouraging ideas. In September, a team of about 15 advisers began to convene every two weeks to discuss an approach to fiscal reform.

The team was given a relatively straightforward task: to generate ideas, no matter how politically controversial, about how the budget deficit could be limited in the short term. On top of it, the budgetary system itself was up for an overhaul that would limit its current inherent short-termism. No structural reforms of pensions, health care or state administration were on the agenda. These were left for the next stage of the reform discussion that should start later this year.

The schedule was very tight, as the first stage of reform proposals were to be drafted by the end of November so they might accompany the final budget 2003 voting in Parliament. The budgetary institutions and other structural reforms would be discussed and possibly approved in the first half of 2003. The master plan has been that the 2004 budget would be based on a new set of institutions (either legislated or adopted voluntarily by the government), approved parametrical reforms and an outlook of systemic reforms. The 2005 budget would then be completely overhauled. There is still time to stick to this plan, but it's getting short…

From the very start, the adviser team's role was limited. No matter how brilliant, no team of 15 economists could ever draft a complex fiscal reform. Therefore, the bulk of the technical work was still vested with the finance ministry and the ministry's experts were present at every meeting. Indeed, the advisers' chief achievement was, to my way of thinking, that they help to stimulate debate among the ministry's own people and that they encourage them to "think unthinkable" and cross many taboos that had existed in the budgetary discussions.

The draft that has meanwhile become "Sobotka's reform" was finished in November and contained only the least controversial of the many ideas that were floated during the sessions. In this respect, it is a timid plan that could, and should, be spruced up.

Crisis in the making

The draft, however, does contain a lucid and thorough illustration of the unsustainability of the current fiscal policy stance. The Czech Republic had a public budget deficit of about 4 percent of GDP in 2002, and the deficit will "stabilize" at around 7 percent of GDP thereafter. This is way above any reasonable level, it disqualifies the country from the EU's monetary union and it risks provoking a fully blown economic crisis. It is impossible to talk away the urgency of the situation but the draft shows that several countries have coped with similar situations, reformed their budgets and have not suffered any social hardship as a consequence.

Given the structure of the Czech budget, where almost a half of the spending goes to social security expenditures, it is evident that the plan focuses on these heavily.

Most important is a change in the pension indexation. If prices are used exclusively instead of wages, the budget could be cut by at least Kč 5 billion annually. Billions could be saved if the current generous and often misused sickness benefits were reformed. Furthermore, social benefits SHOULD BE AWARDED not only on income BASIS, but wealth SHOULD BE TAKERN INTO CONSIDERATION AS WELL in order to eliminate their misallocation to the relatively well-off. The draft calls for cuts in EXTENSIVE HEALTH CARE NETWORK FOR INTRODUCTION OF CO-PAYMENTS, AND FOR MORE TRANSPARENT AND COST SENSITIVE DRUG COMPENSATION POLICY.

The plan also envisages some savings in the current construction saving scheme that is subsidized by Kč 14 billion a year. The number of state government employees should be cut by 2 percent annually, while their wages would grow by a massive 16 percent in 2004 to make the sector more attractive. The state guarantees would be limited, and while off-budget funds like the National Property Fund and Czech Consolidation Agency would be eliminated, others like the notorious Transport and Housing Funds would be integrated back into the state budget to bring them under central government and finance ministry control.

The plan is much less innovative in its tax policy, and for a good reason. Taxes are already high in the Czech Republic, and there is little room for raising them. The plan envisages three substantial changes: first, some goods would be moved from the 5 percent to the 22 percent VAT rate, generating some Kč 20 billion a year.

Second, the self-employed would pay higher contributions to the state budget – currently they calculate their contributions from 35 percent of their income, and this share would rise to perhaps 65 percent, adding about Kč 5 billion to the state budget. Last, corporate tax would fall from 31 percent to 28 percent with a debatable effect on tax revenues. Altogether, the proposed changes in the tax system are limited to cases where one can argue that the current system is inefficient. No doubt, any increase in tax revenues will be painful for taxpayers, but given the grave fiscal position it seems to be the price that must be paid.

Give and take

Combined, the proposed reforms would lower the deficit by Kč 50 billion in 2004 and by Kč 70 billion in both 2005 and 2006. One third of the adjustment would come from higher taxes, two thirds from lower expenditures. Even after this, the deficit would remain close to 4 percent of GDP, higher than in all EU countries and higher than the euro ceiling.

That's why the proposed plan is only a beginning and why we have argued for the second-stage reforms that would tackle the roots of the fiscal crisis. These reforms should incorporate some proposals that were left out of the first draft. Mainly, the Czech social system must lessen its attractiveness for long-term users of the system. As has been illustrated, the current guaranteed income is so high that it pushes many workers out of the labor market and into addictive social benefits. Thus, a two-stage living minimum standard that would lower benefits after a period without a job should be considered.

Also, a complete elimination of some social benefits (funeral benefit, transport benefit, etc...) is likely to be on the agenda as they are costly to administer and serve a negligible social purpose. Other benefits' eligibility should be tightened, especially for the children benefits that should be targeted at below average income families, not at 90% of families as now. Radical pension reform remains on the cards, but requires an independent analysis

The Czech fiscal situation is grave. Without reform, the country is headed for a crisis, sooner or later. Given the scope of the problem, no expenditure should be sacred. However, spending on most pro-growth items should be maintained or raised, including on education, research, justice, police and defense. In some areas, private financing should be attracted (education, infrastructure).

But for the rest, the belt-tightening will be painful. However, the reforms should not be demonized. We are not talking about dismantling the entire social security system or about halving the government's payroll. The adjustment that awaits us is economically straightforward. It is, however, politically explosive and politicians tend to dither. The more they talk about it, the more they fear the reform, and the more they rattle the public. A maneuver that could have been done with no much hullabaloo has risen to "the most ambitious reform ever attempted" which is unfortunate. The real reform must follow this mere adjustment phase.

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