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Improving the Efficiency  
and Sustainability of Public  
Expenditure in the Czech  
Republic

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**IMPROVING THE EFFICIENCY AND SUSTAINABILITY OF PUBLIC EXPENDITURE IN THE  
CZECH REPUBLIC**

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by  
**Andrew Burns and Kwang-Yeol Yoo**

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## ABSTRACT/RÉSUMÉ

**Improving the efficiency and sustainability of public expenditure in the Czech Republic**

This paper reviews the public expenditure system in the Czech Republic and the scope for its reform. In recent years much progress has been made in improving the transparency and management of government finances. Nevertheless, the budget and policy planning process retains a single-year and input-oriented focus. Moreover, with the recent introduction of a regional level of government and the expansion and proposed introduction of new extra-budgetary funds, the government's capacity to manage the macroeconomy has been weakened. In this regard, establishing a multi-year budgetary process should be made a government-wide priority. Such a system would allow extra-budgetary funds to be re-integrated into the State Budget. Moreover, it would reduce the potential for expenditure creep and facilitate macroeconomic policy making, as would the establishment of mechanisms for co-ordinating sub-national spending programmes. Such a medium-term budgetary framework should evolve, over time, into a fully-fledged output-oriented medium-term expenditure framework. To improve programme effectiveness, more emphasis should be placed on measuring and evaluating outputs.

*JEL classification:* H0, H1, H4, H5, H6, H7

*Keywords:* Public expenditure, general government, extra-budgetary funds, contingent liability, fiscal discipline, budgetary transparency, multi-year budgeting.

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**Améliorer l'efficience et la viabilité des dépenses publiques en République tchèque**

La présente note examine le système des dépenses publiques en République tchèque et la possibilité de le réformer. D'importants progrès ont été faits ces dernières années en vue d'améliorer la transparence et la gestion des finances publiques. Néanmoins, le processus de planification et d'établissement du budget s'inscrit toujours dans un cadre annuel et reste centré sur les ressources mises en oeuvre. De plus, avec la création récente d'un niveau régional d'administration et le développement des fonds extrabudgétaires ainsi que l'augmentation de leur nombre, les autorités sont moins à même de gérer la politique macro-économique. A cet égard, la mise en place d'une procédure budgétaire pluriannuelle devrait être une priorité à tous les niveaux d'administration. Un tel système permettrait de réintégrer les fonds extrabudgétaires dans le budget de l'Etat. Il réduirait en outre le risque de dérapage des dépenses et faciliterait la formulation de la politique macro-économique, au même titre que l'adoption de mécanismes visant à coordonner les programmes de dépenses des niveaux d'administration infra-nationaux. Un tel cadre budgétaire à moyen terme devrait progressivement se transformer en un véritable cadre de dépenses à moyen terme, axé sur les résultats. Ces derniers devraient être mieux mesurés et évalués pour améliorer l'efficacité des programmes.

*Classification JEL :* H0, H1, H4, H5, H6, H7

*Mots-clés :* Dépenses publiques, administrations publiques, fonds extra-budgétaires, engagements conditionnels, discipline budgétaire, transparence budgétaire, programmation budgétaire pluri-annuelle.

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## TABLE OF CONTENTS

Introduction .....	4
Public expenditure in the Czech Republic.....	5
International comparison and aggregate developments .....	6
Expenditure management .....	8
Central government.....	9
Sub-national government .....	11
The planning horizon .....	15
Guarantees and other contingent liabilities .....	16
Ex post and ex ante policy evaluation.....	18
Maintaining fiscal discipline throughout the cycle .....	19
Policy challenges .....	19
Improving sub-national co-ordination mechanisms.....	20
Reducing fiscal risks associated with contingent liabilities .....	20
Introducing a multi-year, medium-term budgetary process .....	21
Integrating extra-budgetary funds into the MTEF .....	23
Improving the effectiveness of public expenditure.....	24
Summing up.....	28
Tables and Figures .....	31
Glossary .....	48
Bibliography.....	49
<i>Annex</i> : Government accounts .....	52

### Boxes

Box 1. OECD adjustments to the GFS accounts .....	6
Box 2. The State Budget process.....	9
Box 3. Extra-budgetary funds.....	12
Box 4. Powers and responsibilities of the new regional governments .....	13
Box 5. New Act on Budgetary Rules .....	16
Box 6. Programme financing initiatives .....	17
Box 7. Introducing a medium-term expenditure framework .....	22
Box 8. Enhancing flexibility in public management .....	27
Box 9. Summary of recommendations .....	29

## IMPROVING THE EFFICIENCY AND SUSTAINABILITY OF PUBLIC EXPENDITURE IN THE CZECH REPUBLIC

by Andrew Burns and Kwang-Yeol Yoo<sup>1</sup>

### Introduction

1. The first decade of the transition in the Czech Republic witnessed a dramatic rise in the share of output produced by privately-owned firms, which rose from only 13 per cent of GDP in 1990 to more than 77 per cent in 1999 (CSO, 2001). Nevertheless, public expenditure remained a more or less constant share of GDP during the period 1993-99. In 2000, it rose to 48.4 per cent of GDP, and is now above the OECD average and higher than in other transition economies such as Hungary and Poland. Meanwhile, revenues have grown much less quickly and, as a consequence, the general government deficit has increased substantially. Moreover, the current imbalance is largely structural in nature and could threaten economic stability over the medium term.

2. Looking forward, these developments and the sustained build-up of “hidden debts” since the beginning of the transition portend a rapid rise in debt and debt-servicing costs. Moreover, a number of medium-term factors are likely to place further pressures on the public purse. In particular, the ageing of the population will increase public health and pension payments, while revenues will be adversely affected by the shrinking of the working-age (and tax-paying) population relative to the number of dependent individuals. At the same time, the creation of new regional governments and accession to the EU are likely to raise expenditures, although EU assistance may help offset costs associated with higher environmental standards, required infrastructural investment and other institutional reforms. Finally, the transfer of spending power from the centre to the new regional authorities and increased reliance on extra-budgetary funds have reduced the share of public expenditure that comes directly under the budget, thereby limiting the authorities’ capacity to execute macro policy.

3. In this overall context, a thorough review of public expenditure and the institutions that govern it appears in order. All the more so because Czechs already face a high tax burden and, not least given the

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1. An earlier version of this paper served as an input into the 2001 OECD Economic Survey of the Czech Republic, which was published in September 2001 under the authority of the Economic and Development Review Committee of the OECD. Andrew Burns is the former head of Czech Republic/Hungary desk and Kwang-Yeol Yoo is an economist in General Economic Assessment Division in the Economics Department. The authors would like to acknowledge Aleš Krejdl and Ondrej Schneider who made substantial analytical contributions to the paper and Drahomira Vasková without whose expertise, tireless energy and enthusiasm this paper would not have been possible. The authors are also indebted to Val Koromzay, Mike Feiner, Andrew Dean, Andreas Wörgötter, Paul Van den Noord, Jaromir Cekota and Isabelle Joumard for valuable comments on earlier drafts. Special thanks go to Margaret Morgan and Chantal Nicq for technical support, and to Anne Eggiman, Diane Scott and Sarah Kennedy for technical assistance. Finally this paper would have been impossible without the extensive assistance of numerous Czech experts in ministries responsible for policy-making in this area.

country's level of development, increasing taxes to meet current and future shortfalls does not appear to be a viable option (see OECD, 2000a). Rather, the authorities need to take a close look at how public money is spent with an eye to improving the efficiency with which services are delivered and using the ensuing savings to reduce the deficit. This will require a substantial transformation of the budgetary and policy formation process, but it is a feasible challenge and essential if medium and long-term budgetary stability is to be achieved.

4. The next section of this paper presents Czech public-sector spending in an international perspective and it is followed by a description of existing expenditure planning and control procedures. The major policy challenges raised by these structures are then analysed and reforms proposed. Finally, the paper concludes with a short summary.

### Public expenditure in the Czech Republic

5. The general government sector in the Czech Republic consists of the central government (State Budget), nine central extra-budgetary funds (including two newly established ones), the healthcare system<sup>2</sup> and local governments. The State Budget is the focus of most political and press commentary and until recently it has been broadly in balance. However, it represents a shrinking proportion of the expenditures of the general government, the balance of which has deteriorated in almost every year since 1993. At the same time, there exist general government accounts produced by the Ministry of Finance using the cash-based Government Financial Statistics (GFS) of the International Monetary Fund (IMF), and accrual-based general government accounts compiled by the Czech Statistical Office (CSO) according to the System of National Accounts. However, the deficits associated with these various measures vary widely and, for this reason, complicate the efforts of evaluating fiscal situation in the Czech Republic (Table 1).

(Table 1. Various measures of the government budget deficit)

6. In this paper, public expenditure refers to that of the general government. Unemployment insurance, pensions and elements of the social-security system are included in the State Budget. As of summer 2001 the government accounts data in the National Accounts compiled by the CSO are only available up to 1998. The CSO plans to produce annual SNA-compatible accounts in a timely manner beginning in 2002 and quarterly accounts beginning in 2003. As a result, the data used here are based on the Ministry of Finance sources, calculated on the basis of the IMF's *A Manual on Government Financial Statistics* (GFS). However, in an effort to improve their consistency with statistics produced by other OECD countries, most of which compile government accounts according to the Systems of National Accounts (SNA), the OECD has made several adjustments to the Czech GFS data. The most important of these include the exclusion of privatisation revenues and of certain local-government asset sales<sup>3</sup> and the booking of the losses of *Konsolidovaná banka* (KoB) in the year after they occurred. In addition to these changes which impact overall revenue, expenditure and the government's balance; the composition of spending is also adjusted to improve comparability across countries. Box 1 describes in more detail the various adjustments made. While closer to SNA concepts, these data are not fully SNA compatible. In the first place, no serious attempt was made to make accrual adjustments and no imputation for the

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2. Obligatory healthcare contributions are collected by the state and distributed to healthcare insurance companies, the majority of which are privately owned but the largest of which is state owned. These pay for services according to fee schedules dictated by the state.
  3. Privatisation revenues in GFS are booked as a negative expenditure under net lending, while in 1998 the sale of options to purchase the share of various gas and electricity distribution companies was booked as a capital revenue.

depreciation of government-fixed capital has been made. Nevertheless -- especially as concerns current revenues and expenditures -- the OECD estimates and official SNA data have similar magnitudes and trends for those years where both are available.

#### Box 1. OECD adjustments to the GFS accounts

The data on public expenditure used in this paper are derived from the official GFS data but several adjustments have been made in an effort to increase the correspondence between GFS expenditure categories and those of the SNA. These include both changes that affect the overall balance of the accounts as well as those that merely reallocate items across categories.

##### Changes that alter aggregates

- Privatisation revenues are treated as a financing item rather than as repayment (*i.e.* negative net lending).
- Revenue from local governments' sale of options on the shares of electric and gas utilities has been treated as privatisation revenue (thus a financing item) rather than capital revenue as in official Czech accounts.
- Loans extended by the state and receipts of principal payments are treated as financing items rather than expenditure or revenue as in official Czech GFS accounts.
- Government transfers to cover the losses of *Konsolidovaná banka*, which are treated in the GFS as subsidies are recorded below the line as net capital expenditures.
- These transfers are recorded in the year after the loss was recorded in KoB's books. Generally, this is the treatment in the GFS but in several instances recording was further delayed -- resulting in a very uneven pattern (see Annex I).
- An estimate of the cost of social-security contributions for government workers is made and is added to both government revenues and expenditures in accordance with the SNA principles (these are consolidated out in GFS).

##### Compositional changes

- Health payments for medical treatment paid for by the compulsory insurance regime, which are recorded as income transfers in the GFS, are re-classified as government non-wage consumption.
- Subsidies to "contributory organisations", *i.e.* organisations providing social services on behalf of the government and non-profit organisations more than half of whose revenues come from the state, are re-classified as government consumption.
- Total government consumption is decomposed into wages and non-wage consumption by subtracting from the adjusted GFS aggregate the product of average general-government wages and employment as reported by the CSO.

#### *International comparison and aggregate developments*

7. During the first several years following the Czech Republic's separation from Slovakia, general government expenditure fluctuated around 44 per cent of GDP. In 1998, after the introduction of a fiscal stabilisation package the year before, it dropped to 41.9 per cent of GDP but this budgetary contraction proved short-lived and, beginning in 1999, expenditure began rising rapidly (Figure 1). By 2000 it had reached 46.4 per cent of GDP, substantially above the OECD average of 37.9 per cent and higher than levels of other low and middle-income OECD countries such as Portugal, Spain, Slovakia and Poland and more than double those of Mexico and Korea (Figure 2). High levels of expenditure are a feature the Czech Republic shares with Hungary, Poland and Slovakia, partly as a legacy of their earlier regimes that left them with highly developed social welfare systems. However, the rising share of public expenditure in

GDP in the Czech Republic contrasts sharply with falling shares in Hungary and Poland -- where, at the beginning of the transition, public expenditure was as high as 55 per cent of GDP.

**(Figure 1. General government expenditure and receipts)**  
**(Figure 2. General government spending and income levels)**

8. The Czech Republic's small debt,<sup>4</sup> low unemployment rates (during much of the 1990s), its comprehensive social-welfare system and a tradition of state involvement in production are all reflected in the structure of public spending by economic category (Figure 3). Debt servicing charges as a share of GDP are, at 1.1 per cent, the lowest among OECD countries. As a result, in terms of primary expenditures,<sup>5</sup> the Czech Republic has one of the highest spending rates in the OECD just behind France, Austria and the Nordic countries and well ahead of other low to medium-income countries (Figure 4). Moreover, virtually all sub-categories of spending are above the OECD average, and higher than those observed in other low to middle-income OECD countries (Table 2). The mix of government expenditure has been characterised by rising "mandatory expenditures"<sup>6</sup> such as social transfers, which increased relatively slowly from 1993 to 1996 before rising more rapidly as the economy slowed down. Similarly, the government wage bill rose steadily between 1993 and 1996 before efforts to cut spending saw wage freezes introduced and the wage bill fell to 7.3 per cent of GDP. For most of the decade, these increases were offset by cuts elsewhere. Investment spending fell from 5.9 per cent of GDP to 5.2 in 1999, while non-wage expenditure on goods and services trended down from some 14.5 per cent of GDP in 1993 to about 12 per cent in 1999.<sup>7</sup>

**(Figure 3. General government outlays by economic category)**  
**(Figure 4. General government primary expenditure)**  
**(Table 2. General government outlays by economic category in OECD countries)**

9. About one-quarter of subsidies are directed towards agriculture (Table 3). Transportation subsidies, including for the railway, are also large. Subsidies to industry are principally focused on supporting the reduction of the mining sector, while a small amount of subsidies to regional development and support for SMEs are also available. Municipalities provided about 27 per cent (in 1999) of all subsidies but further detail is not available. Finally employment in the general government sector has been stable at some 15 per cent of total employment in the second half of 1990s. However, public employment, including that of public enterprises, is much higher at 23 per cent of total employment, down from 30½ per cent in the first half of 1990s (Table 4).

**(Table 3. Subsidies as defined in the state budget)**  
**(Table 4. General government employment in selected OECD countries)**

10. Looking at the functional distribution, spending in the Czech Republic does not look much different from that in other countries. The expenditure share of "pure" public goods such as general public services and defence remained relatively stable at 6 per cent of GDP during the mid-1990s, though a drop was observed in 1997 (Table 5). Merit goods, such as education and health, accounted for some 11 per cent

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4. Gross debt in the Czech Republic was only 19 per cent of GDP in 1993 as compared with 88 per cent in Hungary and 68 per cent in Poland (in 1994).

5. Total expenditure less interest payments.

6. These are discussed in more detail below.

7. Wages in the public sector are undergoing a moderate catch-up process with respect to those of the private sector. CSO data on average wages indicate that public sector wages rose faster than in the private sector until levels equalised in 1997. Since then public-sector wage growth has been extremely volatile due to a wage freeze in 1998 and a large rise in 1999.



throughout the 1990s -- roughly in line with most of OECD member countries, although relative to other middle-income countries, the Czech Republic spends relatively more on health (6 per cent of GDP) and less on education (4½ per cent in 1997). Spending on economic services (the provision or co-funding of private goods and service consumption by the state) is higher than in most advanced OECD countries (6 per cent of GDP), but is similar to other middle-income countries such as Portugal and Spain. Social transfer spending in 1997 was particularly high and was even higher in 2000 (12½ per cent of GDP in 2000).<sup>8</sup> Pension outlays in the total are much higher than average. Compared with Portugal and Spain, the Czech Republic spends much more on universal benefits such as family cash benefits and less on unemployment benefits.

**(Table 5. Structure of government outlays by function)**

11. While not recorded as government spending, personal tax expenditures appear mainly focused on poverty alleviation and at 3½ per cent of GDP in 1999, exceed by a wide margin social assistance spending (Table 6). Pension-related exemptions -- both contributions and benefits are tax exempt -- are the second largest form of tax expenditure at 1.1 and 1.9 per cent of GDP respectively with the latter number a better estimate of the total tax expenditure.<sup>9</sup> Investment and regional development incentives form the next largest form of tax expenditure. Moreover, they are likely to grow because the number and size of these investment incentives have expanded importantly in recent years. Associated tax expenditures will only begin to be observed when these investments begin to generate profits.

**(Table 6. Tax expenditure)**

**Expenditure management**

12. The evolution of public expenditure and its structure at any given time is the result of a complex process in which society's needs, the political process and budgetary and policy-making institutions interact. The Ministry of Finance is increasingly attempting to raise the profile of the notion of the general government when discussing fiscal policy and government spending in general. Indeed, beginning in 1999 the financial balance of the general government sector as a whole has been reported in budget documents and during the course of 2000 the authorities made a point of reporting estimates of the general government deficit alongside those of the State Budget. Nevertheless, the budget process and parliament's attention remain concentrated on the State Budget, which in 2000 represented some 66 per cent of general government spending. The Czech government also operates a number of extra-budgetary funds,<sup>10</sup> which represented some 5 per cent of general government spending in 2000. That share is expected to rise to 11 per cent of the state budget in 2001 following the establishment of two new funds and increased spending by the National Property Fund to clean up the banking sector. Finally expenditures of the local

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8. The functional category of social transfers largely overlaps with the economic category of income transfers. However there exist minor differences; for example, the latter includes income transfers to other countries (*e.g.* contributions to international institutions), whereas the former does not include non-cash social services (they are rather classified as merit goods).

9. It could be argued that a policy which exempted contributions but taxed benefits does not constitute a tax allowance because the income is taxed once. Similarly one that taxed contributions and the interest component of benefits could be construed as neutral. Therefore, the total expenditure associated with pensions is probably best estimated as 1.9 per cent.

10. They are the Culture Fund, the Fund for Support and Development of Czech Cinematography, the Environmental Fund, the Soil Fertilisation Fund, the Infrastructure Fund, the Housing Fund, the National Property Fund, the Czech Land Fund and the Agriculture Intervention Fund (formerly known as the State Fund for Market Regulation).

level of government comprise some 19 per cent of overall spending.<sup>11</sup> In addition, the fiscal activity of the government has and continues to include the creation of various contingent liabilities.

### *Central government*

13. The *State Budget* is produced annually in a process that begins with the preparation of the closing accounts of the previous year by the Ministry of Finance. Based on this exercise and its most recent macro projections, the Ministry of Finance, in combination with the cabinet, proposes spending ceilings for the forthcoming year (Box 2). Following an iterative process between Cabinet, line ministries and the Ministry of Finance a draft budget is presented to Parliament, usually in September. It then passes through three readings (and frequently substantial amendments) before being passed towards the end of the year. Despite new requirements that line ministries present multi-year estimates of programme spending (see below), the budget process retains a one-year focus and line ministries' estimates are not consistent with the multi-year fiscal outlook presented by the Ministry of Finance after the budget is finalised.<sup>12</sup>

#### **Box 2. The State Budget process**

The *state budget* is the largest and most visible component of public expenditure. It covers the expenditures (and revenues) of individual ministries as well as transfers that offset the spending of some extra-budgetary funds and those of district and municipal authorities. Early in the new year the budget process begins with the Ministry of Finance preparing its closing statement comparing the previous year's budget with the original estimates. After updating its macroeconomic projection (including revenue estimates) in March and April, the Ministry of Finance circulates to spending ministries a guideline for budget proposals, including a statement of the government's policy priorities and indicative spending ceilings for each ministry on the basis of the previous year's budget. Based on these guidelines, ministries make detailed spending proposals within their assigned ceilings together with prioritised lists of existing and new measures that cannot be funded within the ceiling. The Ministry of Finance reviews these "bids" for additional funding -- mostly at the working level. It then presents its revised budget proposal to the cabinet in parallel with the proposals of the spending ministries in cases where there was no agreement with the MoF. These competing proposals are then discussed and ministry spending ceilings are agreed to. These are proposed to parliament as a draft budget, usually by the end of September.

The Chamber of Deputies of the Parliament (the lower house) discusses, amends and ultimately approves the state budget in three stages. During the first reading, it determines the total volume of the state budget revenues and expenditures, the budget balance and the volume of transfers allocated to sub-national governments and municipalities. Once set, these budget quantities can no longer be modified, although individual items within these aggregates can be reallocated over sub-categories. During its second reading, the budget passes to various committees, with the Budget committee assuming a lead role by taking recommendations from the others and integrating them into a new budget proposal. After the third reading, Parliament votes on the final version of the state budget that now includes alterations proposed during the second stage. Following approval, each ministry translates the budget allocations into finalised programs and adds sub-programme detail. Spending ministries are given a wide range of flexibility in distributing resources across programs as only the total volume of individual chapters of the state budget is fixed by the budget.

14. The Treasury Division of the Ministry of Finance monitors compliance with the State Budget on an ongoing basis and provides the government with quarterly reports. All changes within the approved budget are also reported to the Parliament in a state-budget compliance report.<sup>13</sup> The state closing accounts

11. The figure includes transfers from the central government.

12. Efforts to generate a bottom-up fiscal outlook have been unsuccessful so far.

13. This consists of data on the state budget cash payments, on banking accounts of the state financial assets operations and on the central government debt and debt service.

include information on the development of sub-national budgets and extra-budgetary funds. According to the new Act on Budgetary Rules, municipalities are required to report on budgetary developments each semester -- allowing this information to be included in half-yearly reports of the general government. In addition to this monitoring function, the Supreme Audit Office (SAO) examines the execution of the state budget on a regular basis to ensure appropriate use of public spending. Owing to their special status, some extra-budgetary funds are not subject to such scrutiny (see below).

15. The *discretionary components of the State Budget* are subject to a hard budget constraint, largely because they have no legal basis other than the Budget Act. Daily updates to treasury accounts permit the Ministry of Finance and spending ministries to track spending carefully and to discern potential problems in a timely manner. During the course of the year, individual ministries are required to respect budget spending limits and the MoF can, and does, impose reductions to discretionary spending programmes in an effort to ensure that overall balance between revenues and expenditures is met.

16. So-called *mandatory spending* includes social transfers, health insurance and debt servicing payments. These accounted for 53 per cent of total state budget expenditure in 2000, up from 43 per cent in 1995 (Table 7), with 6 percentage points of this increase due to social transfers alone. When other quasi-mandatory items such as military spending and wage expenses of public administration are classified as mandatory, the share of mandatory expenditures in the State Budget rises to more than 80 per cent. Notwithstanding the treasury division's monitoring process, the Ministry of Finance's capacity to restrain mandatory expenditures within a given year is seriously limited because such spending is dictated by independent legislation and cannot be reduced except by amendment to such laws. However, spending between years is affected by political decisions and is susceptible to expenditure planning. Indeed, past decisions to raise mandatory spending during the period of perceived economic and fiscal strength contributed significantly to the 10 per cent of GDP increase in this kind of spending between 1995 and 2000. For example, had pension benefit levels increased only by the amount prescribed in the 1991 law governing their indexation,<sup>14</sup> OECD calculations suggest that spending in this area would have increased by only half as much as actually observed in the period 1993-2000 (Figure 5). Indeed, fully one-quarter of current pension spending, or about 2.9 per cent of GDP, can be traced back to explicit political decisions to increase the generosity of pensions.

**(Table 7. Mandatory spending)**  
**(Figure 5. Pension spending under various indexation rules)**

17. *Tax expenditures* (tax allowances and credits) are not explicitly considered within the state budget nor addressed in a separate official document.<sup>15</sup> Although, like more traditional expenditures, they seek to promote various policy goals, they are not subject to the same intensity of governmental and

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14. In 1993, pensions were indexed to inflation alone and had to be adjusted whenever the cumulative increase in the CPI reached 10 per cent. In 1995, but entering into effect in 1996 the indexation rule was changed to include, in addition to CPI inflation, one-third of real wage increases and the trigger was reduced to a 5 per cent rise in CPI. A 1997 reform reduced the generosity of the system by changing the formula to 70 per cent of the change in CPI plus 30 per cent of the increase in wages and reasserting temporarily the 10 per cent threshold. The threshold returned to 5 per cent in 1999.

15. Tax expenditure reporting began in Germany and the United States in the late 1960s, with Austria, Canada, Spain and the United Kingdom introducing it in the late 1970s. Australia, Belgium, Finland, France, Ireland, Italy, the Netherlands and Portugal followed in the 1980s. In Austria, Belgium, France, Germany, Portugal, Spain and the United States, the authorities are legally obliged to produce a tax expenditure report and in five of these countries (Belgium, Finland, France, Portugal and Spain) it is explicitly linked to the budget process. Austria and Germany produce subsidy reports, including tax expenditure. In other countries, tax expenditure reports are separate documents and in the United States, it is reported as part of the government's budget but is not integrated into the process.

parliamentary scrutiny. The revenue impact of new tax expenditures is analysed when they are proposed but there is no process by which they are reviewed once in place and their costs are not calculated on a regular basis.

18. *Extra budgetary funds* are only partly integrated into the state budget process. At present, there are seven “standard” extra-budgetary funds and two special ones, the National Property Fund (FNM) and the Czech Land Fund (Box 3). Most of the standard ones are small and existed prior to the transition. They depend on special acts authorising specific budgetary operations and laws earmarking revenues to these tasks. Until recently, the share of these funds in total spending was declining, but this process came to an end in 1999 when the State Fund for Transport Infrastructure and the State Housing Development Fund were created. Most funds fall within the purview of a Ministry, which is usually in charge of determining its use of resources and its overall management. Funds and the programmes they finance are not subject to the same budgetary rules as the State Budget. In particular, the approval and monitoring processes are not as comprehensive and some are allowed to carry over their surpluses, can borrow from financial markets, issue guarantees and finance their deficits by selling their assets or reducing their deposits. Although the government and parliament approve their budgets, the State Budget only specifies and monitors the direct funding provided to extra-budgetary funds. Given their capacity to take on debt, their actual spending can exceed that amount substantially. Thus, even though extra-budgetary funds accounted for only 4.8 per cent of consolidated general government spending in 2000, they accounted for 36.5 per cent of the overall deficit. Indeed, in recent years most of the increase in the general government deficit has occurred within the extra-budgetary sector with the majority of the shortfall having been generated by the National Property Fund.<sup>16</sup> While, much of this reflected explicit political decisions to minimise the recorded state budget deficit, it also likely reflects spending drift. The National Property Fund is particularly free from close supervision. Although the Supreme Audit Office does conduct audits of specific FNM activities, it cannot audit its overall performance. Moreover, while subject to government oversight via its supervisory board, the decisions on how the FNM disposes of its revenues or issues guarantees are not subject to parliamentary approval.

### ***Sub-national government***

19. The fiscal relationship between the central and sub-national levels of government is complicated. Until 2001 there was no regional level of government *per se* although 77 district offices supervised the distribution of central government services among 6 251 independent municipalities.<sup>17</sup> Local government spending accounted for 21 per cent of general government primary expenditures, but their revenues (both own and shared central tax revenues) were equal to only 51 per cent of that amount -- transfers from the central government (about 24 per cent of total local expenditures) and privatisation revenues made up the rest. Local governments are responsible for delivery of most social services in the Czech Republic and this is reflected in the high share of merit goods, such as housing, recreation and transportation that they deliver (Table 8). Although internationally consistent data are not available, it would appear that, compared with other OECD countries, sub-national governments in the Czech Republic spend less on the provision of merit goods such as health and education, although at the general government level spending ratios are about average.

### **(Table 8. Expenditure by level of government)**

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16. Thus between 1993 and 2000, the state budget balance, as a per cent of GDP, deteriorated by 3.2 percentage points, while that of the extra-budgetary funds worsened by 7.1 percentage points.

17. As of 1 January 2001, there were 6 259 independent municipalities.

### Box 3. Extra-budgetary funds

There are nine extra-budgetary funds in the Czech Republic of which eight are included in the general government account.<sup>1</sup>

#### Small funds

The *State Fund for Support and Development of Czech Cinematography* was founded 1992, and is responsible for financing cinematic projects. Its funding is determined by law and is relatively minor.

The *State Fund for Culture* was founded in 1992 and is responsible for creating new financial resources and institutional bases for cultural projects.

The *State Fund for Soil Fertilisation* was established in 1970 and is of minor importance. It is concerned with returning land to agriculture and water flow administration. Its main revenue sources include old claims (repayments), which are decreasing. Since 1990, it has not received direct state funding.

#### Medium-sized funds

The *State Housing Development Fund* is an instrument for securing extra-budgetary resources to support rental house construction, technical infrastructure and reconstruction. Its revenues derive mainly from the State Budget subsidies and grants from the National Property Fund. In addition, it has revenues from issued bonds and mortgage notes, instalments on credits, interest on deposits, penalties, insurance benefits and other payments from physical and juridical persons and contributions from the European Commission.

The *State Fund for Transportation Infrastructure* finances the development, construction, maintenance and modernisation of roads and highways, inland water roads and railways. It seeks to provide projects with budgetary stability by allowing unspent revenues to be rolled over into future years. Its revenues consist of: transfers from the National Property Fund and earmarked fees such as the road tax, highway-fees, yields of securities, credits, deposits and insurance benefits; juridical contributions from the European Commission, gifts and inheritance.

The *State Environment Fund* was created in 1991 and finances efforts at protecting and improving the living environment and in implementing state environmental policy. Its main revenues are fees related to water pollution, air pollution and waste disposal, and levies on the withdrawal of land from agriculture and forestry. The fund can receive transfers from the state budget and can provide subsidies, guarantee and extend loans.

#### Large and special funds

The *Czech Land Fund* was established in 1991 and is also funded from privatisation revenues, mostly profits from real-estate sales and the rental of state assets. These revenues can be supplemented by transfer from the state budget and the National Property Fund but only in case of emergency as provided for by the law. It has a legal status comparable to that of the FNM.

The *National Property Fund* (FNM) is the most important extra-budgetary fund in terms of resources and expenditure. It was founded 1991 and is charged with implementing the privatisation decisions of Government. In the case of the direct sale it negotiates for the state and in the case of public tenders, it manages the process. When a privatisation project includes the creation of a joint-stock company and the subsequent sale of its shares, the FNM initially creates the joint-stock company and, until the sale is complete, is its main shareholder. The main revenue of the FNM consists of privatisation receipts. Basically, its resources may be used to reduce the debts of the state (*i.e.* paying non-recoverable claims of privatised firms and compensating owners of privatised firms for pre-existing ecological damages). Its special legal status makes it partially exempt from the usual scrutiny of the Supreme Audit Office.

1. The Agricultural Intervention Fund (formerly the State Fund for Market Regulation) provides mainly services on a market basis and is classified as "trade organisation". It is not included in the general government sector in accordance with GFS and ESA principles.

20. Following elections in November 2000, 14 new regional governments with democratically-elected assemblies came into being. While the full extent of their powers and

responsibilities have yet to be decided (Box 4 provides an overview of what is currently known), the introduction of a new layer of sub-national government does not appear to have changed the budgetary role of municipalities. Their activities continue to lie outside of the state budget and the budgetary planning process; a considerable amount of their funding still comes from shared tax revenues and they still administer a number of important social programmes that are designed and paid for by the central

#### **Box 4. Powers and responsibilities of the new regional governments**

##### **Introduction**

Under the previous political system, territorial administration within the Czech part of the Czechoslovak Federation was performed by seven centrally-controlled regions (*kraje*), subdivided into 73 subordinated districts (*okresy*). Municipalities were, in turn, subordinated to the district authorities. Beginning in 1990, this centralised model was replaced. Regions were completely abolished, the districts became detached parts of the central administration and more than 6 000 municipalities were granted control over primary education and complete autonomy in a number of areas, including the delivery of social services and public housing.

Following the dissolution of the Federation with Slovakia in 1993, the Constitution of the new Czech Republic mandated the establishment of regional self-governing regional administrations. However, these were not created until 1999, when parliament legislated the creation of fourteen regions (including the capital region of Prague). The first elections to regional assemblies were held in November 2000 and the new regions began to exercise their administrative functions in January 2001. The current legislation establishes a transitional period lasting to the end of December 2002 during which the central government will gradually delegate more competencies to the regions while the existing districts will be replaced by about 190 new micro-districts whose administration will be entrusted to the yet to be selected municipalities or county seats (*pov••ené obce*).

##### **Functions and expenditure assignments**

###### **Regions**

The 14 regions have been delegated responsibility for managing secondary education (high schools as well as vocational schools) and selected health care (most hospitals) and social care (large residential facilities) functions. In addition, they are responsible for the maintenance of secondary highways and roads, waste management and water protection.

###### **Municipalities and counties**

Under the old system, the district offices performed four basic functions: serving as detached units of the central government's ministries, deciding on appeals of decisions of municipal authorities, supervising the use of financial transfers to municipalities and establishing local organisations of the delivery of public services in the areas of culture, education, health, social services and safety. As of 2001, some functions, assets and employees of the district offices have been transferred to the new regional administrations. The remaining functions and resources will be transferred to the new county offices by the end of 2002.<sup>1</sup> The 190 county offices will be responsible for monitoring decisions and ordinances issued by municipal authorities to ensure that they do not violate the law but municipalities are not subordinate either to the regional or county levels of government. They remain responsible for the management of child nurseries and senior citizens' homes, environmental protection, local transport, maintenance of local roads, primary schools, public housing, public safety and zoning by-laws.

##### **New revenue assignments**

###### **Regions**

During the 2001-02 transitional period, regional administrations will be financed directly by grants from the central budget. Tax sharing arrangements for the post 2002 period are under discussion but regions are expected to be assigned a share in all the tax bases available to municipalities (see below) although shares will differ. It has yet to be decided whether regions will be allowed to impose specific tax surcharges. The central government will

**Box 4. Powers and responsibilities of the new regional governments** continued

continue to provide the grants financing the operation of regional assemblies, administrative agencies and secondary schools. Excepting teachers' salaries and school textbooks, grants will not be earmarked and regions will be allowed to use these revenues as they see fit. Regional governments will be allowed to take bank loans; however, their use of collateral will be restricted to assets specified in binding agreements with central authorities.

***Municipalities and counties***

From 2001 municipalities as a whole will receive 20.59 per cent of VAT, corporate income tax and wage, interest and dividend-related personal income tax revenues. As a group, municipalities will receive 14.413 per cent of other personal income tax revenues -- mainly those from unincorporated businesses. The actual revenue intake of each municipality will be based on its population, adjusted for size by a coefficient increasing from 0.42 for the smallest settlements of less than 100 inhabitants to 2.76 in the case of Prague with more than a million residents. In addition, each municipality will receive 30 per cent of the personal income tax paid on unincorporated business revenues by its residents. County seats will take over some responsibilities from the current district offices and 'inherit' corresponding transfers from the state budget.

In addition to revenue sharing, another major source of municipal revenues will be provided by the following *current* grants from the central authorities. First, unconditional grants will be provided to municipalities from the relevant state budget chapters, on a per capita basis, to finance social security, pre-school and primary education, children hospitals and administrative functions. Second, districts and eventually counties will receive a special transfer from the state budget. Third, programme financing will be provided and monitored by the relevant line ministry of the central government. Fourth, conditional cost-sharing grants will be provided to the municipalities participating in crime prevention, addiction treatment, active-labour-market and heritage-restoration activities. *Capital* grants, which account for approximately one-tenth of all grants will be provided on a cost-sharing basis for construction and maintenance of public housing, primary schools, natural gas networks, management of water supplies and environmental activities.

The Finance Ministry will monitor the fiscal position of local governments. Districts and later counties must present to the Ministry their audited accounts on a monthly basis whereas municipalities' audited accounts are due quarterly. It is expected that from 2003 the county administrations will monitor the flows of transfers from the central government to municipalities. In order to ensure an adequate level of municipal governance, all municipal clerks will be required to pass competence tests administered by the Ministry of Interior. Municipalities remain exempt from the provisions of the Bankruptcy Act, which is likely to make them less appealing to creditors.

**New public employment patterns**

In 2001, 685 new deputies of regional assemblies started to perform their duties. The new regional governments are expected to hire 1 385 new employees and an additional 1 300 civil servants are to be transferred from the central and district levels -- representing an immediate net increase of 2 070 in public sector employment. As the details of this new and complicated governance structure are worked out and with the establishment of 190 county administrations to replace 77 district offices, there is a significant risk that public-sector employment will expand even further.<sup>2</sup>

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1. All told some 900 municipalities will receive some delegated powers, the most basic of which being those of collecting vital statistics. Of these some 700 will also be charged with issuing building permits, 389 with maintaining land and business registers while about 190 will have the full range of district office functions delegated to them.
  2. Indeed, the Czech Statistical Office indicates that the 0.3 per cent increase in public-sector employment in the first quarter of 2001 was mainly due to the regional reform.

government. The budgetary process for municipalities is similar to that of the central government. Each municipal administration prepares its own budget after taking into account available funding from the central government and the municipal assembly approves some version of this. Municipalities are required by law to publish a budget outlining revenues and expenditures by mid-year. Beyond assuring itself that these and other legal requirements are met, the central administration does not approve local government

budgets, which are the sole competency of each municipal assembly. However, because municipalities are dependent on central government transfers for some 24 per cent of their total revenue, the central government is able to exercise some budgetary influence at the local level. Municipalities are free to take on debt and may approve a deficit budget provided municipal guarantees or collateral cover the planned shortfall. The central government regularly monitors sub-national public borrowing and has at its disposal various sanctions and penalties for municipalities that fail to provide required levels of collateral. In case of financial difficulties, municipalities can ask the Ministry of Finance for temporary financial assistance -- but it is not obligated to provide it and for the moment the issue has not arisen.

21. To date the substantial independence of local governments has not resulted in accumulations of large debts, partly because municipalities supplemented their current revenues with significant privatisation proceeds. As these resources inevitably run out, deficits may become more common. Alternatively, the already noticeable tendency for the quality of delegated services provided by municipalities to vary with their capacity to generate own revenues may become more severe. Here the ability of the central government to monitor service provision, a task currently executed by district offices, appears weak. So far, too little time has passed to comment on the spending behaviour of regional governments. However, despite incomplete specification of their relations with the central government, it would appear that they too will be subject to only limited control.

### *The planning horizon*

22. The budget and policy planning processes have a relatively short-term horizon, although recent steps have extended it somewhat. As a result, policy makers are ill-equipped to judge the longer-term implications of their decisions, although the inclusion of a medium-term (five-year) fiscal projection in the 1999 budget was an important first step towards redressing this deficiency. The exercise was curtailed somewhat in the 2000 budget when the outlook was limited to three years and this shorter horizon has been incorporated into the new Budget Rules. These forecasts include only aggregate figures for overall revenue, expenditure, deficit and public debts in the general government sector. They are not integral to the budget process, and they are only presented after the budget is decided. As such, they act as an *ex post* illustration of medium-term fiscal pressures given the decisions already taken, rather than as an *ex ante* statement that might shape decision-making. Thus the projections included in the 2000 budget contrasted two scenarios, while the three-year fiscal outlook associated with the 2001 budget consisted of four . Despite their shortened horizon, these scenarios also helped highlight the urgent need for strong fiscal consolidation measures to avoid a vicious cycle of higher deficit, rising debts and lower growth.

23. More recently, the authorities have attempted to deal with the medium-term impacts of policy changes on a more systematic basis. The new Act on Budgetary Rules (Box 5) requires that line ministries include in their estimates explicit three-year projections of individual budget lines and also requires most extra-budgetary funds to report medium-term budgets. In addition, each new draft law must now be accompanied with a medium-term estimate of its budgetary impact. While the Ministry of Finance comments on these, there is no requirement that they be approved by it and for the moment they are not aggregated to provide a consistent overall multi-year budget projection. Indeed, efforts to perform such an aggregation for the 2001 budget were unsuccessful -- suggesting that the detailed projections conflicted with the medium-term fiscal outlook. Moreover, some ministries or inter-ministerial advisory commissions have established various multi-year plans. However, these tend to be *ad hoc* and are developed outside of the cabinet process, reflecting individual ministerial rather than government-level objectives. As a result, they too are often inconsistent with one another. While they are not binding upon the government, they tend to serve as blueprints for the future within ministries, frequently imposing spending increases on the ministerial agenda that then have to be negotiated in the annual budget process.



### **Box 5. New Act on Budgetary Rules**

A New Act on Budgetary Rules was approved by parliament in 2000 and entered into effect in 2001. It contains seven major changes.

*First*, the scope for variation from the original budget documents has been reduced. Unexpected revenues can no longer be spent without parliamentary assent, transforming approved expenditure estimates into an overall cap. Mandatory expenditures and EU related spending are still exceptions to this rule. Individual budget chapters may exceed estimates by a maximum of 5 per cent but only if this increase is offset by reduced spending elsewhere and is approved by the Ministry of Finance or the Cabinet. Within budgetary chapters, individual spending lines may not exceed original estimates by more than 10 per cent without parliamentary approval, even if the overall chapter ceiling is observed.

*Second*, rules on government guarantees were tightened substantially. Each individual guarantee must now be approved in a separate law, either at the time of the budget submission or separately. Moreover, the total volume of state guarantees has been capped at 40 per cent of revenues.

*Third*, new rules concerning capital investment and maintenance introduce multi-year controls on such projects. Investment programmes costing more than CZK 5 billion must have explicit government approval based on programme document assessment. After programmes are approved, the detailed specification of programmes and progress in those programmes should be registered in the electronic "Asset Replacement Financing Information System" managed centrally by the Ministry of Finance to facilitate monitoring and evaluation (see Box 6).

*Fourth*, a minimum budgetary reserve of at least 0.3 per cent of the expenditures of the state budget was created to cover necessary but unforeseeable expenditures.

*Fifth*, spending can only be undertaken by legally approved institutions. As a result, the previous practice of establishing special spending institutions by ministerial decree will be discontinued.

*Sixth*, the budgetary presentation and monitoring were made more transparent and accountable. The state budget must now include a broad medium-term outlook covering two years beyond the budget under consideration. Moreover, the quarterly reports to parliament are to become more timely and user-friendly. Half-yearly reports are to cover the operations of the extra-budgetary funds, include a semi-annual focus on budget deviations and propose remedies to overruns.

*Seventh*, the government can no longer operate on the basis of an unapproved budget. Under the old rules, the provisional budget for next year is regarded as the same one that the government proposes, even if was rejected by parliament. Under the new rules, the government must limit its total monthly expenditure to one-twelfth of the previous year's total until a new budget is approved (common practice in many OECD countries).

24. Moreover, special budgetary procedures have been introduced for investment projects. The "Program Financing Initiative" was designed to allow the government to commit funding to selected investment projects beyond the annual budget cycle and into the medium-term horizon (Box 6). For a programme to be included under the initiative, a proposal must be made that includes a description of the work to be done, its rationale, a statement of the financial resources that it will require over its life and a cost-benefit analysis of the project. Once a project is accepted into the programme, the Ministry of Finance uses a newly devised database system to monitor spending and progress of multi-year projects.

### ***Guarantees and other contingent liabilities***

25. State guarantees and other contingent liabilities are a legitimate component of a government's public expenditure tool kit. Contingent liabilities grew very rapidly during the past decade and now represent close to 15 per cent of GDP -- almost as much as the official debt -- and, as such, they represent a significant fiscal risk (Table 9). The bulk of these liabilities were accumulated in an unplanned manner,

having arisen because of the poor management of the banking sector, in addition to state-ownership and bailouts of large, heavily indebted firms. The largest component is represented by the liabilities of *Konsolidovaná banka* (KoB), which enjoys a 100 per cent state guarantee, and to which some 30 per cent of GDP in bad loans were transferred.<sup>18</sup> Most recently, the cost of restructuring large state-controlled firms has further increased its liabilities. Moreover, these estimates underestimate the liabilities generated by state-owned firms, some of which have been offset by transfers from the National Property Fund, while others have yet to be realised and exist in the form of substantial unpaid inter-company loans.<sup>19</sup>

**(Table 9. Outstanding loan guarantees by risk category)**

**Box 6. Programme financing initiatives**

Programme Financing Initiatives (PFI) are pre-approved investment projects and their associated maintenance and repair costs. Project financing is determined after an evaluation of programme proposals, their motivation, expected costs (over several years), detailed description of programmes and sub-programmes, necessity and required resources, objectives and economic rationale. Approval for state budget financing or state loan guarantees is granted by the government if the amount exceeds CZK 5 billion and by the Ministry of Finance if less than that amount.

Once programmes are approved they are registered in the “Asset Replacement Financing Information System”, which tracks and monitors progress on a regular basis. The progress reports serve as basic information in drafting the state budget, the closing state accounts and medium-term outlook. Separate binding indicators common across individual chapters were created to ensure sufficient financing of approved investment programmes over the medium term. These cannot be modified without the consent of the Ministry of Finance.

Currently approved programmes include industrial zone construction and development of backward regions. It is premature to evaluate how these initiatives will help improve the effectiveness of investment spending as this year will be the first year to fully implement the programme financing initiatives. However, it is obvious that chosen investment projects will be financed smoothly through the construction cycle and any deviation from original spending estimates can be minimised. Nonetheless, it does not appear to help selection of competing investment projects. Furthermore, the coverage of PFI procedures is limited to the state budget and thus does not apply to the substantial investment progress undertaken by extra-budgetary funds.

All investment programmes are expected to be reassessed during the second and third quarter of this year according to a new act on budgetary rules and a ministerial decree. From 2002, financial support will be approved only for the programmes that fulfil the conditions specified by the new budgetary rules.

26. A further significant off-budget liability has been created by the issuance of loan guarantees, whose volume has increased dramatically, rising from CZK 28 billion in risk-adjusted terms to CZK 104 billion (5.3 per cent of GDP) between 1996 and 2000. Guarantees have been used as a non-transparent substitute for subsidies and for government consumption and investment expenditure that would normally have been recorded in the budget -- often with no expectation that loans would be repaid. Indeed, of the 39 guarantees outstanding at the end of 2000, the state expects to be called upon to cover either interest or principal payments on all but four during the course of 2001. “High-risk” and “special” guarantees (defined as those with a 90 per cent or higher probability of default) accounted for 78 per cent of the total and were used to cover infrastructure programmes such as modernisation and construction of

18. KoB’s official liabilities stood at CZK 199 billion in the first quarter of 2000.

19. Some large state-controlled enterprises participating in the government sponsored revitalisation programme already owed CZK 9.5 billion of health insurance contribution to another state-owned entity, health insurer (VZP). Similarly, the state railways owe substantial sums to state-owned power companies.

railways, roads and highways.<sup>20</sup> This suggests that the authorities have used guarantees to by-pass spending ceilings agreed in the budget process. Other guarantees, such as those accorded to Czech railways (CD), representing 14 per cent of all risk-weighted guarantees, are made in lieu of subsidies to cover losses stemming from the performance of public services. The above total for guarantees excludes open-ended ones and most importantly the one granted to *eskoslovenská obchodní banka* (CSOB) when it agreed to take over *Investni•ni a poštovní banka* (IPB). Current estimates suggest that the state's exposure from this guarantee could be in the order of CZK 50 to 180 billion (2.5 to 9 per cent of GDP) -- potentially doubling the volume of outstanding guarantees. Finally, the total is further underestimated because it excludes guarantees made by Czech export-import credit organisations and household loan guarantees and does not include guarantees made by extra-budgetary funds such as the environmental guarantees of the National Property Fund (FNM).<sup>21</sup> By the end of 2000, such guarantees totalling CZK 146 billion have been issued and CZK 11.25 billion paid. The FNM expects the government to approve some new environmental guarantees and that an additional CZK 77 billion are likely to be called.

27. A growing recognition of the fiscal risk represented by these contingent liabilities, prompted the government in 1999 to require the Ministry of Finance to systematically monitor and report on their developments in the state budget and its closing state accounts, indicating the volume of state guarantees and estimates of their potential budgetary impacts. Similar information is given as regards the financial performance of the National Property Fund and that of transformation institutions, along with related future commitments. At the same time, a cap of 8 per cent of state budget revenues was placed on the total volume of additional guarantees that could be extended in a year. These measures were partially reinforced by the new budgetary rules. Beginning in 2001, the government is prohibited from issuing new guarantees without the permission of parliament and the total of outstanding guarantees is limited to 40 per cent of revenues, although the 8 per cent limit on new ones has been lifted. Despite these improvements, no reserves or explicit planning for their realisation are incorporated into the budgetary process, nor is the aggregate liability that they represent calculated or reported. Moreover, the new budgetary restrictions on the issue of guarantees do not apply to the two extra-budgetary funds with a special, quasi-private legal status (FNM and the Czech Land Fund). As a result, the government retains the ability to create further contingent liabilities without parliamentary authorisation.

### *Ex post and ex ante policy evaluation*

28. While some evaluations of the effectiveness of policies are undertaken, they are not conducted systematically, nor are policies designed with an eye towards their evaluation. Moreover, there is no institutional requirement or incentive for line ministries to systematically review the extent to and the efficiency with which their programmes meet original policy objectives or whether those have changed. Thus sunset-clauses that require a programme to be abandoned after a certain time period unless it can justify its continuance are rarely employed. Performance is determined by the extent to which a ministry respects revenue and expenditure estimates. Neither budget chapters nor enabling laws for mandatory programmes include much in the way of specific indicators as to the use to be made of public money, the goals to be achieved or metrics by which programme success can be evaluated. *Ex post* evaluation mainly takes the form of audits of the degree to which ministries fulfilled their legal obligations -- budgetary and

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20. Rather than include in its budgetary accounts the full costs of requiring CD to provide subsidised transport to some sectors of the population, the state provides it with guarantees on loans that have no expectation of being paid. The annual increment to the railroad's debt was 0.25 per cent of GDP in 2000 and the cumulated total reached 2 per cent of GDP in 2000.

21. During the privatisation process, the FNM decided with the agreement of the government to cover costs of any clean-up associated with pre-sale environmental damage.

otherwise. While the Supreme Audit Office recognises the value of output-focused audits and its mandate does not preclude them, it persists in performing more classical input-oriented examinations.

### *Maintaining fiscal discipline throughout the cycle*

29. Since the beginning of the transition the Czech economy has yet to complete a full business cycle, the post-transition contraction not being a normal cyclical downturn, and the current recovery has yet to reach its peak. Moreover, the extensive build-up of contingent liabilities and quasi-fiscal spending by state-controlled banks during the 1990s complicates the evaluation of the stance of fiscal policy and its sensitivity to the cycle. Nevertheless, the OECD indicators of fiscal stance (Table 1) and estimates of the structural deficit suggest that fiscal policy has responded pro-cyclically throughout the 1990s. The gradual expansion of the structural deficit in the period 1994 through 1996, though masked by the strength of the economy, was mainly due to the permanent increases in entitlement payments discussed earlier and these undoubtedly contributed to the overheating of the economy and the 1997 currency crisis. The fiscal tightening incorporated into the subsequent stabilisation package concentrated upon cuts in such discretionary expenditures as investment and non-wage public-sector consumption. This contributed to a sharp fall in the structural deficit in 1998 but these cuts proved unsustainable and their relaxation in 1999 is reflected in the increase in the structural deficit. Thus, most of the 2.1 percentage points increase in the deficit between 1996 and 1999 represented the operation of automatic stabilisers. Indeed, higher social security expenditures and declines in tax revenues account for more than all of the increase. However, the rapid deterioration in 2000 and 2001 (as budgeted) is mainly due to substantial hikes in discretionary spending -- with the main categories being increases in government consumption and net capital outlays of 0.9 and 0.8 per cent of GDP respectively.<sup>22</sup>

### **Policy challenges**

30. The past several OECD *Economic Surveys of the Czech Republic* have emphasised the need to improve budgetary transparency and much has been done in this regard. In particular, the government in its public pronouncements increasingly refers to the balance of the *general government* as the most important indicator of its fiscal stance. Moreover, considerable effort has been made to enumerate the extent of the contingent liabilities that have built up during the first decade of transition. However, despite this progress, public expenditure planning remains principally a state budget process. As such, the expenditures and activities of municipalities and the newly created regions are not dealt with in an integrated manner, while those of the wide and growing range of extra-budgetary funds are dealt with incompletely. Indeed, the share of the state budget in total expenditure will probably shrink from 64 to 39 per cent if plans to create a new extra-budgetary fund for pensions and sickness benefits go ahead as planned (Figure 6). The implications of these changes given the current public expenditure framework are described below, where it is argued that resort to extra-budgetary funds should be limited. Moreover, in order to ensure better overall control of macroeconomic policy, mechanisms need to be built into the regional and municipal budgetary process that place reasonable limits on their spending autonomy but which, nevertheless, preserve their ability to allocate funds as they deem most appropriate.

### **(Figure 6. Expenditure shares in general government)**

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22. Income transfers increased 0.6 per cent of GDP and KoB related transfers added 1 per cent of GDP to the deficit including these expenditures.

***Improving sub-national co-ordination mechanisms***

31. The new regional reform appears to pose serious potential problems for public expenditure management -- not least because the various responsibilities and powers of the central government, the 14 regional governments, the 190 county "seats" (delegated municipalities) and some 6 250 ordinary municipalities are not yet fully defined. The new government structure will probably raise overall costs. In the area of social-transfer administration, government officials expect staffing levels to double and costs could rise even higher as regions gain control over their spending. Simultaneously, the reform, by devolving spending to autonomous regions, significantly reduces parliamentary control over public expenditure. While sub-national borrowing is not guaranteed by the state, it is uncertain how the central government would deal with sub-national government default. A proposed amendment to the regional government act, currently before parliament, would require municipalities and regions to gain parliamentary or Ministry of Finance approval before issuing bonds. In addition, it would allow the central authorities to place sub-national governments that were unable to pay their obligations into forced administration. Both of these measures, if passed, would reduce moral hazard, help prevent the build-up of sub-national debt and provide the central government with some additional influence over the stance of fiscal policy at the sub-national level.

32. In order to reinforce these steps, the government should give serious consideration to creating a binding mechanism for co-ordinating spending across the various levels of the general government. At a minimum this should involve a regular series of meetings between Ministry of Finance officials and their regional equivalents to discuss budgetary developments and ways that sub-national levels of government can contribute to overall fiscal management. A more ambitious programme would integrate regional and local levels of government into the budgetary process and would require them to negotiate their spending and deficit targets with the central authority.<sup>23</sup> While the content of the spending would remain a regional prerogative (thus preserving the benefits of subsidiarity), such a mechanism would greatly reduce the likelihood of uncoordinated fiscal impulses. As municipalities are explicitly not subordinate to regional governments, they could be asked to co-ordinate in a similar manner through their county administrations.

***Reducing fiscal risks associated with contingent liabilities***

33. The build-up of contingent liabilities, mainly through the accumulation of bad loans in the banking sector and the losses of poorly and partially privatised firms, has represented a substantial and, until recently, largely uncontrolled and unmeasured component of public expenditure. As a result, the annual increments to the public debt have far outpaced recorded deficits. Indeed, the so-called hidden debt is almost as large as the official debt and would exceed it by a substantial margin if the present value of future pension liabilities were included.

34. The government's decision to enumerate these liabilities in its budgetary documents is an important step to internalising the risks that they pose to public finances. However, they remain only partially integrated into the budgetary process and, given their size, steps need to be taken to deal with them in an open manner. Thus, in addition to existing reserves to deal with expected calls on government guarantees, additional ones should be built into the budget to cover the realisation of other less tangible

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23. A number of OECD countries restrict the budgetary autonomy of sub-national governments in this way, including the Netherlands, Spain and even Germany where *Länder* explicitly negotiate spending under some cost-shared programmes with the federal government (Wurzel 1999).

liabilities -- such as the environmental guarantees of the National Property Fund,<sup>24</sup> future pension liabilities and costs associated with the clean-up of the banking sector. Moreover, to aid in this kind of planning the current enumeration of the size of contingent liabilities should be supplemented by an evaluation of the probability of their realisation.

35. By the same token, new legislation requiring parliamentary approval for loan guarantees should reduce the likelihood that they be used as a substitute for more transparent support for firms. So far, no such requirements have been imposed on sub-national governments and this should be rectified to ensure that a similar build-up of “hidden debt” does not occur there. In addition, more needs to be done to ensure that guarantees are not merely substituting for current expenditures. To this end, the government should create general guidelines that specify the criteria and conditions for provision of government guarantees with an eye to restricting their use to situations where a guarantee is necessary to overcome a readily identifiable market failure (as in the case of export-import credits).<sup>25</sup> Guarantees and the institutions benefiting from them should be subject to regular monitoring and *ex-post* evaluation. Specifically, legislation governing the National Property Fund should be amended so that it can no longer create contingent liabilities without prior parliamentary approval.

36. Finally, in order to permit the government to identify and measure the overall impact of various policy programmes, tax expenditures should be integrated into the budgetary process. A list of expenditures together with their revenue costs should be provided for government and parliamentary review. Where possible, the incidence of these tax expenditures should be made clear. Such a list, which should classify tax expenditure by function, would help legislators evaluate programmes and enhance public awareness of the cost of tax expenditures. Concretely, considerable savings could be generated by subjecting either pension contributions or benefits to taxation. The current double exemption costs almost 2 per cent of GDP and is most unusual.

### *Introducing a multi-year, medium-term budgetary process*

37. The Czech government’s reliance upon a single year budgetary framework undermines fiscal discipline in two ways. First, the medium-term consequences of decisions that influence mandatory spending programmes are not adequately considered. Second, the single-year framework contains a natural incentive to delay payments associated with programmes (either real or their recording) into the future. The increases of the generosity of pension benefits in the early 1990s represents a clear example of the first problem, while repeated delays in the recording of the losses associated with *Konsolidací banka* illustrate the second. Recent steps to present a medium-term fiscal outlook with budget documents is a step in the right direction, as is the new requirement that ministries provide multi-year projections of the costs of spending programmes and of new policy initiatives. However, neither of these initiatives addresses the fundamental flaws of the current system. On the one hand, the medium-term fiscal outlook only reports aggregate figures on revenue and expenditure and does not contain any information on spending at the ministerial or budgetary chapter level. Moreover, the projections are produced after the budget proposals, they perform only an *ex post* informational role and do not help guide the formation of the budget. On the other hand, the medium-term budgetary estimates that line ministries must now produce for both existing

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24. Currently calls to compensate environmental damages are paid from the reserves (or revenues) of the National Property Fund and not the State Budget. However, as is recommended below, were the Fund to be included in the general government an explicit reserve would be required.

25. Such a guideline would take the form of guarantee contracts that would specify criteria for determining whether government should make payments, actions for recovering amounts paid and the application of risk sharing schemes. These should impose deductibles on debtors and preserve the right of the government to abrogate contracts in case of morally hazardous behaviour.

and new programmes are not subject to any external (*i.e.* Ministry of Finance) controls to ensure that they are consistent with macroeconomic assumptions. Nor are they aggregated to produce an overall budgetary projection.

38. These problems could be addressed by expanding the scope of the medium-term projections and integrating them into an explicit multi-year budgetary process. Indeed, the recently introduced “Programme Finance Initiative” is a good starting point for investment projects. Experience in a number of OECD countries<sup>26</sup> suggests that, assuming the necessary political will, a fully-fledged medium-term expenditure framework (MTEF) could be introduced in the Czech Republic relatively quickly (Box 7). Such frameworks, which are being implemented in more and more OECD countries, have several advantages. *First*, they make explicit the future costs of existing and proposed programmes -- forcing politicians to come to terms with the medium-term consequences of their decisions. *Second*, they provide a clear mechanism through which alternative spending proposals can be evaluated by the cabinet. *Third*, they provide spending ministries with more budgetary certainty by implicitly extending the government’s

#### Box 7. Introducing a medium-term expenditure framework

Moving towards a Medium-Term Expenditure Framework (MTEF) would initially require an iterative process, beginning with centrally determined budget estimates for the next several years, based on the macroeconomic outlook, current policy commitments and government policy priorities. These would be used to determine total spending allocations for major budgetary sectors and the prospective budget balance.<sup>1</sup> On this basis, spending ministries would be asked to prepare detailed “notional” budgets for the next several years. While ministerial allocations and legal requirements of spending programmes would have to be respected, ministries would be allowed to reallocate funding from less to more efficient programs within their portfolios. These detailed proposals would then be submitted to the Ministry of Finance to ensure their consistency with the previously determined aggregate spending limits. The first year of these estimates would form the budget for that year, while subsequent estimates would form the starting point for the budget process in future years. Policy and tax changes proposed during the course of the year would be required to include detailed estimates of budgetary costs and, if passed, these changes would be incorporated into the baseline.

In the second and subsequent years, these baseline estimates would represent authoritative limits on government spending, revenues and the deficit -- assuming unchanged policies. During preparations of later budgets, the baseline would be rolled forward and revised in line with changes in macroeconomic conditions. Ministries would be then asked to extend their projections a year and indicate what additional funding they might require for planned policy reforms and what savings could be achieved. The cabinet would then evaluate these program initiatives, set inter-sectoral priorities and decide which proposed changes to accept. If the government decides not to adjust the baseline for a ministry or a specific programme, the agency promoting the change would either have to abandon its plans or finance them from savings made elsewhere in its budget portfolio.

1. It is recommended that major spending across sectors be determined at this stage to improve enforceability of the MTEF. Australia’s forward estimates are structured into 17 portfolios, each of which is the responsibility of a minister. In Sweden, spending is divided into 27 sectors when aggregates are decided.

spending commitments over several years. *Fourth*, by explicitly detailing future costs, MTEFs make transparent the long-term implications of decisions to increase spending by more than the minimum prescribed by law. Perhaps most importantly, they simultaneously place the annual budget process into

26. Australia, the Netherlands, New Zealand, Sweden, the United Kingdom, and the United States are among countries where projections based on the previous year’s budget form a starting point for subsequent years’ budget negotiations. A further 12 OECD countries use multi-annual expenditure targets.

both a historic and a forward-looking perspective that impedes the kind of incremental expenditure creep that characterises annual systems. At the same time, they promote greater budgetary stability by making explicit the impact of the economic cycle. In this way, they reduce the likelihood that a government would have to resort to precipitous cuts in its discretionary spending in order to rebalance macro policy -- or that in an effort to redress a short-term slowdown it increased its long-term commitments and structural budget deficit.

39. While the current public administration has the technical capacity to implement a MTEF, for it to be successful would require a broad political consensus. Its implementation would need to be closely followed by the government and be given high priority. Budgetary rules and practices would have to be redefined and it might be necessary to create an Expenditure Review Panel to oversee their implementation.

### *Integrating extra-budgetary funds into the MTEF*

40. Establishing an MTEF would facilitate the integration of extra-budgetary funds into the state budget, thereby increasing fiscal transparency and parliamentary control over spending. Currently, although the revenues and expenditures of extra-budgetary funds are discussed in the budget process and must be approved by parliament, fund-related spending is not examined as closely as regular budget programmes. Moreover, funds can exceed spending limits without authorisation up to a specific ceiling established by the enabling legislation, while two funds (the FNM and Czech Land Fund) are allowed to borrow without legal limit and carry with them open-ended government guarantees.<sup>27</sup> Finally, because spending undertaken by these Funds lies outside of the state budget, the scope for reallocation of resources in line with governmental priorities is limited.

41. The planning horizon implicit in an MTEF would provide the medium-term budgetary stability that extra-budgetary funds are supposed to provide, while still subjecting programmes to a political process where their expenditures have to be justified and compete with alternative priorities. Just as provisions for rollovers in some funds have been created, similar provisions could be made for programmes within a multi-year budgetary process. Failure to re-integrate these programmes and continuing to insulate them from budgetary rules, risks jeopardising allocative efficiency and perpetuating spending on programmes that are no longer needed. For these reasons and especially because of a tendency for the general government budget deficit to be concentrated in the activities of these funds, the OECD has consistently argued that they be abolished and that their activities be integrated into the state budget.

42. The proposed Social Insurance Fund is something of a special case. The government argues that creating such a fund will help heighten individuals' recognition of the interaction between their contributions, their pensions and the Fund's performance. By making more transparent the linkages between pension rules and the financial health of the fund, they hope that its creation will reduce the population's resistance towards necessary pension reform. They see it, therefore, as an initial step in a process of pension reform. While a legitimate line of reasoning, such an extra-budgetary fund poses the same kinds of problems for expenditure management as described above -- although given the size of the proposed fund their magnitude would be even larger. Indeed, earmarking some 24 per cent of general government revenues to this programme would clearly reduce the authorities' capacity to manage macro policy and reflect evolving priorities in government spending. Moreover, creating another extra-budgetary fund does nothing to address the current deficit of the pension system or its projected increase over the medium and longer term. Indeed, unlike such funds in other OECD countries the Czech fund would not be

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27. Some government oversight is assured because the Funds supervisory boards contain government appointees.



a device through which temporary surpluses are accumulated (in isolation from political spending pressures) so as to defray future liabilities. Rather, the proposal actually envisions endowing the Fund with proceeds from privatisation and using these to pay down its current deficits, which are projected to grow substantially over time. While some of the associated elements of the plan would make small steps to improve its long-run sustainability, these could as easily be introduced if the pension system remained within the budgetary sector. Indeed, rather than creating a new fund, the authorities should integrate the tax collection function of the social security administration with that of the Ministry of Finance, as was recently done in Hungary. Not only would this generate savings by reducing duplication of services -- it could well improve the government's ability to fight tax evasion.

### *Improving the effectiveness of public expenditure*

43. In order to shift the focus of the policy formation and budgetary review processes from costs alone to costs and benefits, the government should take steps to systematically integrate output indicators into the budgetary and policy-making processes. Existing ones are too concerned with measuring inputs and too little oriented towards monitoring and evaluating the impact of these inputs. Only when elected officials and ministerial policymakers are armed with concrete information on the effectiveness of alternative programmes will they be able to make rational choices about how to use public money in the most cost-effective way. Although conceptually simple, measuring the output of government programmes is difficult in practice and demanding of a country's public service. While it is probably not feasible to introduce a fully-fledged output-oriented budgeting system in the Czech Republic immediately, over the near term a number of relatively simple changes could be introduced that would make such a transition substantially easier in the future.

44. As a first step, specific spending programmes should be introduced with sunset clauses that require them to be abandoned after a set period of time (typically several years), unless parliament renews their mandate. Such a simple measure, which can be introduced retroactively, helps prevent programme and spending inertia from developing. It increases the ability of politicians to re-orient spending as policy priorities change and protects against the development of a culture of acquired rights, which can substantially constrain a government's room for manoeuvre. To be most effective, programmes subject to sunset clauses should be designed in such a way that their outputs can be measured. In particular, the performance of specific purpose programmes such as household transfers, tax expenditures, subsidies and labour market programmes should be evaluated regularly and required to justify their continuation. Moreover, legislation governing larger programmes such as pensions and health care should be modified to require periodic reviews and regular presentation to parliament of long-term projections of both demands and expected costs.

45. Evidence suggests that some specific programmes may not be achieving their policy goals as efficiently as possible. Thus, while many of the components of the Czech social-transfer system are well focused and substantially increase the incomes of individuals in the lowest decile, others are much less so. Using data from the Czech Household Consumption Survey, which includes detailed data on household market and non-market incomes as well as taxes paid, Schneider (2001) shows that, taken as a whole, the Czech social security raised the incomes of the poorest 10 per cent of households by some 34 per cent in 1999 but it also raised the incomes of the richest three deciles by between 1 and 3 per cent (Figure 7). There is some room for increasing the system's targeting. In particular, the targeting of child and parental benefits could be improved substantially and the savings could be used either to reduce overall spending or to improve benefits to the poorest. If such benefits were clawed back from individuals in the fifth through tenth deciles the pecuniary penalty for households would be small but the budgetary savings could be as

high as CZK 1.3 billion or 0.07 per cent of GDP.<sup>28</sup> A similar examination of tax expenditures, shows relatively good targeting at the low end of the income distribution but a perverse increase of benefits to the richest half of the population. This effect is principally a result of providing income-tax deductions, which entail a greater benefit to individuals who pay higher marginal tax rates. It could be eliminated, with an estimated saving of CZK 19 billion or 1 per cent of GDP, by replacing these deductions with tax credits equal in value to the deductions received by poorer tax payers.<sup>29</sup>

**(Figure 7. Social transfers and the distribution of income)**

46. By the same token, successive *Surveys* have argued that labour market training and public-employment programmes in the Czech Republic should be subjected to systematic evaluation. Evidence from other OECD countries suggest that such programmes tend to have low impacts on worker employability or earnings potential and the few studies<sup>30</sup> that have been done in the Czech Republic concur with this result. Indeed, as reported in OECD (1998) as many as 60 per cent of social benefit recipients are not seriously looking for work, despite this being an eligibility criterion for many benefits, suggesting that there is considerable scope for improving the effectiveness of active labour-market programmes and perhaps reducing costs.

47. The effectiveness of subsidies -- especially housing subsidies -- is also not very clear. Support for domestic housing construction and renovation, including both subsidies and tax expenditures, represents some 2.8 per cent of GDP, but their impact on house construction and renovation activity is small.<sup>31</sup> In 1999, the central government housing subsidy was CZK 29 billion or almost 50 per cent of total output in the housing construction and renovation sector (World Bank, 2001). Moreover, the subsidy appears poorly targeted, mainly benefiting the middle class because they enjoy a higher share of untargeted subsidies such as grants for new construction and mortgage-cost tax deductions.<sup>32</sup> A lack of housing is a real issue in the Czech Republic and impedes labour mobility. However, as long as rents are kept well below market rates by rent controls it is unlikely that any amount of housing subsidy will create the much needed market in rental accommodation (see OECD, 2000a, for a more thorough analysis). Thus deregulation of the rent-setting process would be a much more efficient solution to the problem. A more aggressive than planned liberalisation of rent controls would allow private capital to step in, obviating the need for government support and at the same time offering a significant saving to the public purse and avoiding the bureaucratic distortions associated with entrenched systems of rent control.

48. The delivery of social services by municipal governments, many of whom have difficulty meeting central standards, is also a source of concern. Even prior to the introduction of the new regional level of government, public spending was subject to considerable subsidiarity<sup>33</sup> with 19 per cent of general

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28. The calculation presupposes that beginning with households in the fifth decile parental and child benefits are taxed at a 10 per cent rate rising to 60 per cent at the tenth decile. On this basis, for a household in the fifth decile, comprised of two adults and two children, the annual cost in terms of benefit withdrawal would range between CZK 5 385 if one parent worked and CZK 2 556 if both worked. At the tenth decile, these costs would rise to CZK 21 088 and CZK 3 931 respectively.

29. OECD (2000a) examined the Czech tax system in detail.

30. See for example Beneš *et al* (1998).

31. The World Bank (2001) indicates a central subsidy of 0.8 per cent of GDP, 0.8 per cent of GDP in tax expenditure and between 1 to 1.2 per cent in the form of municipal housing subsidies.

32. Ministry for Regional Development, reported in World Bank (2001).

33. The subsidiarity principle argues that certain public goods and services are most efficiently delivered at the local level, particularly when their consumption is geographically limited. By matching the supply of such goods and services with the particular preferences and circumstances of a given constituency, local

government spending undertaken by municipal governments. Because of their small size (80 per cent have a population of less than 1 000), many municipalities are unable to manage the kinds of programmes for which they are given responsibility in an effective manner. In addition, the central government exercises limited control over the quality or extent to which these services are performed. While monitoring the fulfilment of these criteria has been the responsibility of district offices, their activities have been restricted to ensuring that allocated funds are spent and eligibility decisions met. Thus, the central government has little idea of how money is spent and although it has an approximate idea of how many beneficiaries are being served on average during the course of a year, it has no precise numbers.<sup>34</sup> As a result, the quality of services delivered tends to vary with the relative wealth of the community. Under the reform this monitoring function is to be transferred to county seats (delegated municipalities) but it is not clear how or why they will assure better monitoring or information systems. Moreover, until now municipalities have supplemented their current revenues and central government transfers with privatisation revenues, suggesting that their revenue base is inadequate to deal with their spending responsibilities and that horizontal inequity will grow as these resources become scarce. The Ministry of Labour and Social Affairs hopes to address many of these issues by raising its capacity to monitor the quality of service delivery -- especially those delivered by non-governmental organisations.

49. Assuring adequate delivery of social services by municipalities is a challenging problem -- both practically and, perhaps, constitutionally. Nevertheless, it is clear that the central government must improve its knowledge both of how its money is being spent and to what effect. The first could be achieved relatively easily by requiring municipalities to report more relevant information, while the second would require programmes and transfer systems to be redesigned. In particular, greater reliance on block grants, coupled with specific output-oriented performance criteria, would give the national authorities more say in programme delivery and monitoring functions. More prosaically, greater attention needs to be paid to enforcing existing rules, ensuring that job-search criteria are being fulfilled and that sub-national governments are providing the kind of services that central government funds are paying for.

#### *Systematic evaluation of programmes and output-oriented indicators*

50. While measures such as sunset clauses and the more systematic evaluation of programme efficiency will help improve public expenditure, for the process to be truly effective the results of these evaluations need to be included in budgetary materials so that politicians can better weigh spending options. Indicators should be reported *ex ante* in the form of goals and *ex post* as a means of verifying performance. While many ministries make such evaluations for internal purposes, integrating them into the budgetary process would increase transparency and serve to make budgetary institutions more accountable for their use of public funds and the services they provide. Such integration would imply major changes to the budgetary and policy formation processes and would take some time to implement. Nevertheless, movement in this direction is clearly desirable and feasible. Initially, the number and nature of indicators in state budget chapters would need to be expanded.

51. Efforts to build an output orientation into public expenditure management will necessarily require substantial changes in the management culture and human resource policies of the government (Box 8). To be most effective, managers and employers need to be rewarded for improving outputs rather than managing inputs. This would require giving discretion to managers on spending within the predetermined

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provision is thought to raise economic welfare above the level that would result from a more uniform delivery system.

34. Data are available indicating the number of spells of benefit receipt during a year, but because of the possibility of multiple spells no data indicate how many people are actually receiving them at any given time or how much each recipient is getting on a monthly basis.

totals, setting expected outputs in advance, maintaining comprehensive performance reporting and auditing systems and linking managers' pay to performance. While elements of this kind of flexible management system already exist in the Czech Republic,<sup>35</sup> they need to be expanded and incentives and control mechanisms need to be carefully designed. More immediately, improved remuneration of managers and highly-educated personnel so as to improve the government's capacity to attract and retain high-quality officials should be a priority. Moreover, plans to limit political appointments to the highest level of the civil service should improve continuity in the provision of services and could be consistent with a more flexible management style.

#### Box 8. **Enhancing flexibility in public management**

A number OECD countries have made efforts to reform the way they organise and manage the public sector.<sup>1</sup> Generally, reform has been centred around constructing accountability frameworks that allow the government to delegate decision making on resource allocation to spending agencies in exchange for holding them responsible for results. Mechanisms for monitoring performance include: financial inducements and sanctions; strategic and operational plans; performance measures and targets; contracts for personal and organisational performance and more active use of *ex post* evaluation and auditing.

Different national traditions with respect to public service and existing degrees of centralisation have been reflected in the specific steps taken. Reform has proceeded farthest in those countries with a history of providing operational discretion to local managers and where the reform effort enjoyed political support at the top of the government. In all cases, a central challenge involved defining new relationships between the centre, which is politically accountable for governmental performance, and operating units, where services are provided and most resources are spent. This task was made more difficult in many cases because strategic controls had to be created to replace *ex ante* controls. At the same time, significant efforts had to be made to change corporate culture within governmental agencies and to motivate managers to take initiative and responsibility, while minimising the disruption of service provision.

Virtually every government has chosen different instruments to enhance the extent to which performance information influences organisational behaviour. Australia relies on programme evaluation both before policies have been initiated and after they have been funded. France emphasises responsibility centres as a means of imbuing civil servants with awareness that their actions can make a difference. Sweden uses annual reports and *ex post* audits of financial reliability and programme performance. The United Kingdom employs framework documents and performance targets to concentrate managerial attention on key objectives and results. New Zealand invests considerable resources in negotiating performance agreements for chief executives and purchase agreements for agencies.

Despite their efforts, each country has inevitably faced failures. None of these techniques has been perfect and inevitably not all decentralised decisions taken are good and some resources have been allocated without regard of objectives and results. Nevertheless, these reforms are globally considered to have contributed positively to making government service more cost effective.

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1. OECD (1997b) deals with reform efforts in various countries in much more detail.

#### *Using market mechanisms to reduce costs and improve services*

52. The government should consider expanding its reliance on private financing of public investment and consumption both to enhance the efficiency of their delivery and to reduce demands on the public purse. At the level of municipalities, a number of them have already privatised water distribution services,

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35. While the budget process dictates total wage bills, line Ministries have considerable discretion as to how they manage their human resources. They are free to change the mix of employees (using more or less professionals for example) as long as they respect the overall spending limit.

but waste collection, child-care services, public building maintenance and cleaning are areas where increased competition could result in greater efficiency and lower costs. The employment of user charges to reduce excess demand and improve public services through the introduction of market signals could also result in improved services, while relieving the general taxpayer of some of the costs.

53. Compared with some systems, the Czech educational system already employs a number of market-oriented mechanisms to boost the efficiency of service provision. At the primary and secondary levels, private schools compete with public ones and both are supported by the state, although private ones less generously. Moreover, students are free to attend any school and funds are partially distributed on a per student basis, a factor which introduces some competition. At the tertiary level, although universities do not have tuition fees, private post-secondary schools exist and a new amendment forces universities to recognise some of the credits granted by these institutions -- thereby introducing some competitive pressure at that level. However, demand for university places far exceeds supply and more could be done to expand access. For instance, the introduction of tuition fees, complemented with a student loan or bursary programme for those in need would simultaneously provide schools with additional revenue to expand capacity and help to rationalise demand pressures.

54. As concerns healthcare, despite the extensive privatisation of medical practices and some hospitals and the trappings of competition (there are several private health-insurance companies), it remains fundamentally a public-sector system. More than 80 per cent of hospitals remain state-owned, participation in the health insurance scheme is obligatory, contribution rates are set by the state while, in general, fees paid to health-care professionals and institutions are negotiated by insurance companies and providers.<sup>36</sup> As a result, private firms compete by attempting to attract the least risky clients -- leaving the most unhealthy segments of the population to be insured by the state-owned insurance company, which unsurprisingly runs a large deficit.<sup>37</sup> The vast majority of health procedures are covered 100 per cent by the state and only dental care and some prescription drugs are co-financed by consumers. As recommended in the previous *Survey*, expanding co-payments would help reduce over-consumption of medical services. Moreover, incentives in the system remain complicated and a fundamental review and reform is overdue if budgetary costs are to be controlled and the efficiency of service delivery improved.

### Summing up

55. The rapid rise in the deficit of the general government in recent years and the expectation that it will remain elevated unless concrete steps are taken to reduce spending or raise revenues means that a comprehensive reassessment of public expenditure programmes is necessary. Moreover, rising health and pension costs as the population ages are likely to increase pressures on the public purse over the medium and long-term. Given the high tax burden already facing Czech citizens and the implications that this may have on potential growth rates (see OECD, 2000a), reducing public expenditure should be a priority. However, as the preceding discussion suggests, if expenditure reduction is to be achieved efficiently and if overall spending is to be effectively controlled in the future, then the authorities will need to improve the way public expenditure is managed. Box 9 summarises the recommendations of this chapter.

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36. The total budget for hospitals is set by the government and the value of various procedures in terms of "points" are negotiated with providers. Actual payments are determined by the total number of points accumulated and the overall budget.

37. Insurance companies include the state-owned "General Health Insurer" (VTP), some ministerial and branch companies, and a handful of private operators.

### Box 9. Summary of recommendations

#### Budgetary reform

- A medium-term expenditure framework should be introduced quickly in an effort to reduce expenditure creep and improve politicians' capacity to evaluate the longer-term consequences of decisions and the relative merits of alternative spending options.
- In order to increase fiscal and parliamentary control over government spending, extra-budgetary funds should be integrated into the state budget and plans to create a social insurance fund abandoned. Virtually all of the benefits that the funds generate for their associated programmes could be provided in the context of a multi-year budgeting process that allowed for rolling over of unused funds in some budget chapters. At a minimum the budgets of the funds should be integrated into the state process.
- Results of programme evaluations should be integrated into budgetary chapters as indicators of programme outputs with an eye to developing an output-oriented budgetary system.
- To preserve the country's capacity to manage the macroeconomy, the government should seriously consider creating a binding mechanism for co-ordinating spending across the various levels of the general government.

#### Introduce systematic programme evaluation

- The government must develop mechanisms to improve its understanding of how (and how effectively) services provided by municipalities are delivered. Greater reliance on cost-shared programmes could help in this regard.
- Specific spending programmes and tax expenditure should be subject to systematic evaluation and sunset clauses should be introduced retroactively to ensure that programmes are regularly reviewed.
- A number of steps could be taken in the near term to improve the efficiency of government expenditure. These include: a review of tax expenditures; increased clawback rates for child-care and parental benefits for households in higher income deciles; subjecting of either pension contributions or benefits to the income tax; a review of the impacts of subsidies; rent-control reform in place of housing subsidies and a revision of the minimum living standard.

#### Further steps to improve transparency

- Substantial progress in dealing with and reporting contingent liabilities should be extended by including estimates of the risk of their realisation and adding sub-national liabilities to the inventory.
- Steps to reduce the probability of guarantees being used as a substitute for budgetary expenditure should be reinforced by creating binding guidelines that preclude their being granted except to overcome market externalities.
- Moreover, the budget should recognise the likelihood that these liabilities (especially guarantees) will have to be paid by including an explicit reserve.
- When the Czech authorities begin producing accruals-based government accounts on a timely basis, these should be adopted by the authorities for fiscal policy purposes.

56. During the course of the transition and especially in recent years much progress has been made in improving the transparency and management of government finances. Nevertheless, the budget and policy planning process retains a single-year and input focus that reduces the capacity of policy makers to effectively allocate public resources. Moreover, with the recent introduction of a regional level of government and the expansion and proposed introduction of new extra-budgetary funds, the government's capacity to manage the macroeconomy has been weakened. In this regard, establishing a multi-year budgetary process should be made a government-wide priority. Such a system would allow extra-budgetary funds to be re-integrated into the State Budget and subject these programmes to a political

process where their expenditures have to be justified and compete with alternative priorities. Moreover, it would reduce the potential for expenditure creep and facilitate macroeconomic policy making, as would the establishment of mechanisms for co-ordinating sub-national spending programmes.

57. Such a medium-term budgetary framework should evolve, over time, into a fully-fledged output-oriented medium-term expenditure framework. To improve programme effectiveness and the government's capacity to monitor programme outputs, specific policies should be subject to regular evaluations and the use of sunset clauses. The results of these evaluations should be progressively included among budgetary indicators. As more of these are developed the budget and public policy management will take a more output-oriented perspective. Not only would the additional performance information help policymakers choose between competing programmes, the existence of such indicators -- coupled with the delegation of accountability and decision making to lower ranks in the civil service -- should also increase incentives within the bureaucracy to improving programmes rather than merely preserving them. There is also room for increasing the role of market forces in the delivery of merit goods such as education and health, while tax expenditures should be integrated into the budgetary review process.

### **Tables**

1. Various measures of the government budget deficit
2. General government outlays by economic category in OECD countries
3. Subsidies as defined in the state budget
4. General government employment in selected OECD countries
5. Structure of government outlays by function in OECD countries
6. Tax expenditure
7. Mandatory spending
8. Expenditure by level of government
9. Outstanding loan guarantees by risk category

#### *Annex*

- A1. Components of the general government deficit and various deficit definitions

### **Figures**

1. General government expenditures and receipts
2. General government spending and income levels
3. General government outlays by economic category
4. General government primary expenditure
5. Pension spending under various indexation rules
6. Expenditure shares in general government
7. Social transfers and the distribution of income



Table 1. Various measures of the government budget deficit

	1993	1994	1995	1996	1997	1998	1999	2000	2001 <sup>1</sup>
	<i>Per cent of GDP</i>								
<b>State Budget</b>	0.5	1.2	-0.2	-0.3	-1.0	-1.4	-1.8	-2.7	-4.6
<b>General government</b>									
<b>GFS</b>									
Including privatisation revenues	2.6	0.8	0.2	-0.4	-1.4	-1.5	-0.6	-3.2	-1.0
Excluding privatisation revenues	0.0	-1.9	-1.6	-1.9	-2.0	-2.4	-1.9	-4.3	-9.1
<b>OECD</b>									
Adjusted	0.0	-1.9	-1.6	-1.9	-2.0	-2.4	-3.9	-5.7	-7.6
<b>SNA</b>									
Including voucher transactions as a capital transfer	-23.3	-3.9	-12.3	-1.9	-2.4	-3.8			
Excluding voucher transactions	-4.3	-3.9	-2.0	-1.9	-2.4	-3.8			
<b>Indicators of fiscal stance</b>									
<b>OECD</b>									
Excluding expenditures on transformation institutions	0.0	-1.9	-1.4	-1.3	-1.4	-1.4	-2.8	-3.5	-5.4 <sup>2</sup>
Including imputed transformation-related debt servicing charges	-0.8	-2.5	-2.2	-2.4	-2.2	-2.3	-3.6	-4.2	-6.5 <sup>2</sup>

1. Budget programme.

2. Excludes from revenues CZK 20 billion in expected UMTS fees.

Source: OECD; Ministry of Finance; Czech Statistical Office.

Table 2. **General government outlays by economic category in OECD countries***Per cent of GDP, 1999*

	Income transfers	Subsidies	Interest payments	Consumption	Net capital outlays <sup>1</sup>	Total outlays
Australia	8.3	1.2	2.3	18.4	1.6	31.8
Austria	18.7	2.7	3.6	19.7	5.1	49.8
Belgium	14.7	1.5	7.2	21.4	3.1	47.9
Canada	11.4	1.1	7.9	18.3	0.0	38.8
<b>Czech Republic</b>	<b>14.4</b>	<b>3.0</b>	<b>1.1</b>	<b>20.2</b>	<b>5.3</b>	<b>43.9</b>
Denmark	17.7	2.3	4.7	25.7	1.8	52.3
Finland	13.2	1.6	3.5	21.5	7.2	47.0
France	18.4	1.3	3.4	23.7	5.3	52.1
Germany	18.9	1.7	3.5	19.0	2.7	45.9
Greece	15.8	0.2	7.6	15.0	5.3	43.9
Ireland	10.5	0.7	2.8	12.7	4.1	30.9
Italy	17.4	1.3	6.8	18.1	4.6	48.3
Japan	15.1	0.6	3.9	10.3	8.1	38.1
Korea	3.2	0.3	1.1	10.1	8.8	23.5
Netherlands	12.5	1.6	4.4	22.8	1.4	42.7
Norway	15.5	2.8	1.9	21.2	4.8	46.2
Poland	17.2	2.1	4.0	15.1	4.1	42.5
Portugal	11.9	1.0	3.2	20.2	4.9	41.3
Spain	12.5	1.2	3.6	17.3	5.0	39.6
Sweden	19.1	2.0	5.5	27.0	2.5	56.0
United Kingdom	13.5	0.6	2.8	18.4	3.8	39.1
United States	10.7	0.3	3.8	14.3	0.9	30.0
Euro area	16.9	1.5	4.4	19.9	4.1	46.7
OECD	13.4	0.8	4.0	16.0	3.4	37.5

1. Net fixed investment plus net capital transfers.

Source: OECD Analytical Database figures underlying *OECD Economic Outlook* 68, December 2000.

Table 3. **Subsidies as defined in the state budget**<sup>1</sup>

	1997	1998	1999
	CZK billion		
<b>State budget subsidies (A)</b>	<b>27.4</b>	<b>25.8</b>	<b>26.4</b>
Ministry of Agriculture	6.2	9.2	9.8
<i>of which:</i>			
Subsidies to agricultural support and guarantee fund	3.4	3.6	2.4
Subsidies to raise the revenues of agricultural producers	0.0	0.0	4.3
Other agricultural supporting programmes	0.0	0.0	2.0
Direct subsidies to forestry	0.3	0.3	0.3
R&D	0.1	0.1	0.1
Ministry of Transportation	5.9	6.6	7.5
<i>of which:</i>			
Personal railway transportation	5.3	5.8	6.0
<i>of which:</i>			
Sharing of costs of railway roads	-	2.1	2.8
Contribution to cover the losses of personal railway transportation	-	3.7	3.3
Principal repayment of a loan for Czech railways	0.0	0.0	1.0
Removal of harms caused by flood	0.3	0.4	0.1
Ministry of Industry	5.0	5.1	5.7
<i>of which:</i>			
Mining reduction	4.3	4.4	3.8
Restoration of harms caused by mining	0.0	0.2	0.2
Support of small and medium size enterprises	0.0	0.0	0.6
R&D	0.8	0.5	0.7
Regional development program	0.0	0.0	0.3
Ministry of Education	2.0	1.5	1.7
Ministry of Labour and Social Affairs	0.2	0.4	0.8
Others	8.1	3.0	0.9
<i>of which:</i>			
Czech Moravian Guarantee & Development Bank	2.0	2.6	0.8
Heating subsidies <sup>2</sup>	5.2	0.1	0.0
Export subsidies	0.9	0.3	0.1
<b>Local budget subsidies (B)</b>	<b>8.9</b>	<b>9.0</b>	<b>9.8</b>
<i>of which:</i> Regional public transportation	-	2.8	3.2
<b>Total government subsidies (A+B)</b>	<b>36.3</b>	<b>34.8</b>	<b>36.2</b>

1. Excludes KoB losses, guarantee calls and damage compensation to bank properties which are originally included in the state subsidies.

2. Since 1998, heating subsidies are classified as a part of state support programme.

Source: State closing accounts of the Czech Republic.

Table 4. **General government employment in selected OECD countries as a percentage of total employment<sup>1</sup>**

	1993	1995	1998
Czech Republic	-	15.4	15.0
(including public enterprises)	-	30.5	22.8
France	21.5	21.6	-
Germany	15.4	14.8	-
Italy	18.0	17.5	17.0
Hungary	-	24.6	22.5
Portugal	15.0	15.2	15.2
(including public enterprises)	15.7	-	-
Spain	15.6	16.2	15.7 <sup>2</sup>
(including public enterprises)	-	18.0	-
Korea	4.7	4.4	4.5
Mexico	12.0	-	11.5 <sup>2</sup>
(including public enterprises)	13.6	-	12.9 <sup>2</sup>

1. Public employment refers to the general government sector excluding social security administrations and public enterprises.

2. 1997 figures.

Sources: Czech Statistical Office; OECD/PUMA PSPE-Public Sector Pay and Employment Database in the Czech Republic; *OECD Economic Surveys - Mexico* (2000).

Table 5. Structure of government outlays by function in OECD countries

Per cent of GDP<sup>1</sup>

	Total expenditure	Public goods			Merit goods			Income transfers						Economic services	Public debt interest			
		Total	Defence	General public services	Other functions	Total	Education	Health	Other social services	Total	Pensions	Disability	Sickness			Family cash benefits	Unemployment	Housing and other benefits
<b>Australia</b>																		
1990	36.4	8.1	2.0	2.9	3.2	10.4	4.3	5.3	0.8	7.8	3.2	1.2	0.2	1.3	1.4	0.6	6.4	3.7
1995	37.7	8.2	1.9	3.0	3.3	10.5	4.5	5.5	0.5	9.0	3.2	1.2	0.1	2.2	2.0	0.3	5.6	4.1
<b>Austria</b>																		
1990	48.3	3.9	1.0	2.9	0.0	11.0	5.2	5.2	0.6	17.9	12.3	1.7	0.2	2.1	1.2	0.4	3.1	4.0
1995	52.2	4.5	0.9	3.6	0.0	11.9	5.3	5.7	0.8	19.2	13.1	1.7	0.2	1.9	1.8	0.4	3.1	4.4
<b>Canada</b>																		
1990	46.7	3.2	1.7	1.5	0.0	12.2	5.4	6.7	0.1	10.8	4.3	1.0	0.1	0.5	2.4	2.5	2.6	9.5
1995	46.3	2.9	1.4	1.5	0.0	12.3	5.8	6.5	0.0	11.5	4.8	1.0	0.1	0.8	1.8	3.1	2.4	9.6
<b>Czech Republic</b>																		
1995	<b>43.9</b>	<b>6.0</b>	<b>2.1</b>	<b>3.7</b>	<b>0.2</b>	<b>11.4</b>	<b>4.7</b>	<b>6.1</b>	<b>0.5</b>	<b>11.4</b>	<b>6.2</b>	<b>1.4</b>	<b>1.2</b>	<b>2.0</b>	<b>0.3</b>	<b>0.3</b>	<b>6.7</b>	<b>1.2</b>
1997	<b>42.3</b>	<b>3.9</b>	<b>1.6</b>	<b>2.3</b>	<b>0.0</b>	<b>11.2</b>	<b>4.5</b>	<b>6.2</b>	<b>0.5</b>	<b>12.5</b>	<b>7.3</b>	<b>1.7</b>	<b>1.1</b>	<b>1.8</b>	<b>0.3</b>	<b>0.4</b>	<b>5.7</b>	<b>1.2</b>
<b>Denmark</b>																		
1990	57.4	6.1	2.0	4.1	0.0	15.7	6.2	5.1	4.4	17.7	6.3	1.8	1.2	1.5	5.4	1.5	5.9	7.3
1995	59.9	6.0	1.7	4.3	0.0	16.5	6.5	5.1	4.9	20.8	7.4	2.2	0.6	1.9	6.3	2.3	5.6	6.4
<b>Finland</b>																		
1990	44.4	3.4	1.4	1.9	0.1	15.2	6.4	6.4	2.5	15.9	7.4	3.3	0.6	1.9	2.1	0.6	1.0	1.4
1995	54.3	3.3	1.6	1.6	0.1	15.2	6.6	5.6	3.0	22.5	8.9	3.9	0.5	2.7	5.5	1.1	1.1	4.0
<b>France</b>																		
1990	50.2	10.1	3.1	3.9	3.1	12.6	5.1	6.5	1.0	18.7	10.9	1.5	0.5	2.1	2.6	1.1	3.3	2.9
1993	55.4	9.2	2.9	4.5	1.8	14.1	5.9	7.1	1.1	20.9	12.0	1.5	0.6	2.2	3.3	1.3	3.1	3.5
<b>Germany</b>																		
1991	47.4	6.4	1.9	4.6	0.0	12.7	4.4	7.1	1.2	16.3	9.7	1.2	0.4	1.3	3.0	0.6	5.3	2.9
1995	49.7	5.2	1.4	3.9	0.0	13.9	4.5	8.0	1.3	18.2	10.7	1.4	0.5	1.2	3.7	0.8	4.5	3.7
<b>Italy</b>																		
1990	53.2	6.5	1.9	4.2	0.4	12.4	5.8	6.3	0.3	16.3	11.9	1.9	0.2	0.6	1.5	0.0	6.2	9.4
1995	52.2	6.5	1.7	4.5	0.3	10.2	4.5	5.3	0.3	17.9	13.5	1.8	0.1	0.4	2.0	0.0	4.6	11.5
<b>Japan</b>																		
1990	31.6	4.4	0.9	3.4	0.0	8.9	3.7	4.7	0.5	10.0	5.0	0.5	0.1	0.2	0.3	2.2	4.3	3.9
1995	36.5	4.5	0.9	3.6	0.0	10.1	3.8	5.6	0.6	12.8	6.2	0.5	0.1	0.2	0.5	2.9	5.3	3.8

Table 5. Structure of government outlays by function in OECD countries (continued)

*Per cent of GDP<sup>1</sup>*

	Total expenditure	Public goods				Merit goods				Income transfers							Economic services	Public debt interest
		Total	Defence	General public services	Other functions	Total	Education	Health	Other social services	Total	Pensions	Disability	Sickness	Family cash benefits	Unemployment	Housing and other benefits		
<b>Korea</b>																		
1990	18.3	6.7	3.9	2.0	0.8	1.8	..	1.7	0.1	1.3	0.8	0.3	..	0.0	0.1	0.2	2.8	0.5
1995	19.2	5.7	2.9	2.0	0.8	5.6	3.6	1.8	0.2	1.8	1.3	0.3	..	0.0	0.1	0.1	3.7	0.5
<b>Netherlands</b>																		
1990	54.9	11.7	2.4	9.2	..	11.4	4.6	5.8	1.0	21.7	8.4	4.6	2.9	1.2	3.4	1.2	6.3	5.9
1995	52.2	11.6	1.8	9.8	..	12.0	4.6	6.5	1.0	19.2	7.5	3.9	1.9	1.0	4.0	1.0	6.4	5.9
<b>New Zealand</b>																		
1990	46.2	6.5	1.8	4.7	0.0	11.4	5.5	5.8	0.1	16.3	7.6	2.0	0.9	2.6	2.8	0.3	0.0	8.5
1994	38.9	5.3	1.1	4.2	0.0	10.6	5.2	5.3	0.1	13.5	6.0	1.7	1.1	2.0	2.0	0.7	0.0	4.8
<b>Norway</b>																		
1990	50.6	6.2	3.1	3.0	0.2	17.1	6.4	6.5	4.2	15.8	6.3	2.8	1.6	1.9	2.1	1.1	7.6	3.6
1993	52.0	6.3	2.6	3.1	0.6	18.4	6.8	6.6	5.1	15.9	6.2	2.7	1.2	2.3	2.4	1.1	7.2	2.8
<b>Portugal</b>																		
1990	45.0	8.0	2.3	2.7	3.1	8.8	4.3	4.2	0.3	9.5	5.3	1.9	0.6	0.7	1.0	0.1	5.7	8.1
1995	49.9	8.3	2.2	2.0	4.1	10.6	5.4	4.7	0.5	12.1	7.3	1.7	0.6	0.7	1.7	0.1	6.3	6.3
<b>Spain</b>																		
1990	41.8	8.6	1.5	1.7	5.3	9.7	4.2	5.2	0.3	13.4	7.8	1.3	0.9	0.2	3.0	0.2	5.5	3.8
1995	45.2	9.9	1.4	1.8	6.7	10.6	4.8	5.5	0.3	14.9	8.9	1.3	1.1	0.3	3.2	0.2	5.9	5.2
<b>Sweden</b>																		
1990	59.1	5.6	2.6	2.9	0.1	18.8	6.8	7.6	4.4	19.2	7.9	2.8	2.5	2.2	2.6	1.2	2.8	4.9
1995	64.5	5.4	2.3	3.0	0.1	17.2	6.6	5.7	4.9	21.2	8.6	2.7	1.1	2.0	4.5	2.1	3.4	6.8
<b>United Kingdom</b>																		
1990	41.4	6.5	4.1	1.9	0.5	10.2	4.3	5.0	0.9	13.7	7.1	1.8	0.4	1.6	1.3	1.5	4.1	3.4
1995	43.6	5.4	3.2	1.9	0.2	11.5	4.6	5.7	1.2	15.6	7.3	2.8	0.2	1.9	1.3	2.1	3.3	3.6
<b>United States</b>																		
1990	34.9	10.9	7.0	2.8	1.0	10.8	5.3	5.2	0.3	8.5	6.2	0.8	0.3	0.2	0.7	0.4	3.1	5.1
1995	34.3	9.2	5.2	2.9	1.0	11.9	5.0	6.5	0.4	9.4	6.5	1.0	0.3	0.3	0.6	0.6	2.8	4.8

1. Expenditure by function may not add up to total expenditure as these are derived from different sources. In particular, expenditures by function refers to fiscal years and total expenditure to calendar year; moreover, total expenditure is net of capital transfers received.

Sources: OECD National Accounts, Social Expenditure Database; *Education at a Glance*, OECD; and *Survey of Current Business*; Ministry of Finance of the Czech Republic.

Table 6. Tax expenditure

	CZK billion	Per cent of GDP
<b>1. Personal income tax</b>	<b>64.2</b>	<b>3.5</b>
Tax allowances	64.2	3.5
Personal allowance	44.0	2.4
Child and spouse allowance	16.5	0.9
Disabled child and spouse allowance	0.1	0.0
Allowance for (partially) disabled person	0.4	0.0
Students allowance	0.3	0.0
Deduction of gifts to municipalities, etc.	0.6	0.0
Mortgage interest deduction	1.6	0.1
Investment deduction	0.7	0.0
<b>2. Corporate income tax</b>	<b>22.0</b>	<b>1.2</b>
Tax allowances	6.9	0.4
Investment allowance	3.4	0.2
Donation relief	0.2	0.0
Relief for non-profit employees	3.3	0.2
Tax credits	1.7	0.1
Tax credits for disabled employees	1.0	0.1
Tax credits for disabled employees	0.7	0.0
Tax exempt income <sup>2</sup>	13.4	0.7
<b>3. VAT</b>	<b>3.0</b>	<b>0.2</b>
<b>4. Excise duties</b>	<b>0.2</b>	<b>0.0</b>
<b>Total tax expenditure</b>	<b>89.4</b>	<b>4.9</b>

1. Measure based on total amounts claimed or estimates from Ministry of Finance.

2. Includes income from regulated rents for flats, collections in churches, etc.

Source: Ministry of Finance.

Table 7. **Mandatory spending**

	1995	1996	1997	1998	1999	2000	2001
	<i>CZK million</i>						
<b>A. Mandatory expenditure treated by law</b>	184 466	225 849	260 215	285 420	304 721	330 401	352 721
1. Social transfers	160 435	184 291	210 642	228 500	247 276	267 923	282 660
Pensions	109 807	127 579	150 231	166 119	177 854	185 900	197 786
Sick leave benefits etc.	18 098	20 445	19 864	18 577	19 337	27 779	28 701
State social assistance benefits	1 195	26 692	29 237	29 637	31 328	32 500	33 240
Earmarked transfers to local budgets	4 112	4 175	5 195	6 644	9 268	11 300	11 883
2. State payment to health insurance system	13 302	16 436	18 362	23 390	27 424	27 754	28 012
3. Debt service	2 647	14 049	17 591	18 545	16 105	17 781	20 509
4. State contribution to housing needs	1 112	2 311	3 826	5 097	6 393	7 190	8 900
5. Transfers to state funds	850	1 050	1 115	1 360	2 888	2 430	4 240
6. Others	6 120	7 712	8 679	8 528	4 635	7 323	8 400
<b>B. Other mandatory expenditures</b>	9 216	4 933	6 378	14 168	5 992	5 380	5 477
1. Mandatory expenditures treated by other legislative norms	162	104	123	411	221	475	672
2. Expenditures ensuing from contracts	9 054	4 829	6 255	13 757	5 771	4 905	4 805
State guarantees	782	90	1 599	6 683	979	3 000	879
Government credits	7 577	4 064	3 591	5 146	3 221	171	2 110
<b>C. Other quasi mandatory expenditure</b>	99 732	113 302	118 606	125 861	135 106	170 300	175 032
1. Military expenditure (exc. Social benefits)	25 855	27 749	28 381	34 335	3 8155	40 127	40 886
2. Wage expenses of public administration and contribution organisations	72 243	84 607	88 902	89 767	94 136	94 770	114 764
3. Capital expenditure predetermined by government decisions and contracts	0	0	0	0	0	30 500	13 140
4. Others	1 634	946	1 323	1 759	2 815	4 903	6 242
<b>State budget expenditure</b>	<b>432 738</b>	<b>484 379</b>	<b>524 668</b>	<b>566 741</b>	<b>596 909</b>	<b>624 484</b>	<b>651 918</b>
	<i>Per cent of state budget</i>						
A. Mandatory expenditure treated by law	42.6	46.6	49.6	50.4	51.0	52.9	54.1
Social transfers	37.1	38.0	40.1	40.3	41.4	42.9	43.4
B. Other mandatory expenditures	2.1	1.0	1.2	2.5	1.0	0.9	0.8
A+B. Total mandatory expenditure	44.8	47.6	50.8	52.9	52.1	53.8	54.9
C. Other quasi-mandatory expenditures	23.0	23.4	22.6	22.2	22.6	27.3	26.8
<b>A+B+C. Mandatory and quasi-mandatory expenditure</b>	<b>67.8</b>	<b>71.0</b>	<b>73.4</b>	<b>75.1</b>	<b>74.7</b>	<b>81.0</b>	<b>81.8</b>

Source: Ministry of Finance.



Table 8. Expenditure by level of government

*Relative share, in percentage*

	1993		1996		1999	
	Central government	Local government	Central government	Local government	Central government	Local government
General public services	67	33	61	39	44	56
Public order and safety	95	5	87	13	82	18
Education	79	21	80	20	82	18
Health	77	23	94	6	94	6
Social security and welfare	94	6	78	22	92	8
Housing and community amenities	20	80	9	91	21	79
Recreation, cultural and religious affairs and services	42	58	36	64	38	62
Transportation and communications	62	38	55	45	53	47

1. Central government includes the social security system while local government includes district offices.

2. Expenditure shares do not necessarily reflect decision making power at that level.

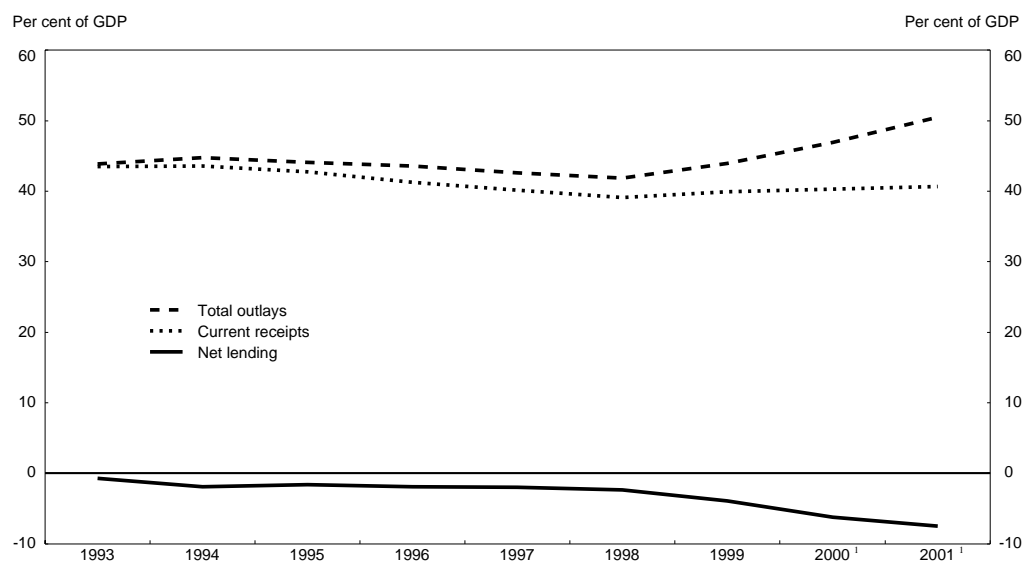
Source: Ministry of Finance, Government Financial Statistics.

Table 9. Outstanding loan guarantees by risk category

State guarantees according to risk weights	Risk weights (per cent)	1999		2000	
		Guarantees outstanding	Risk adjusted	Guarantees outstanding	Risk adjusted
Category I - Low risk	5	19 818	991	15 697	785
Category II - Medium risk	30	13 739	4 122	14 301	4 290
Category III - High risk	90	76 854	69 199	63 124	56 812
Category IV - Special guarantees (high risk)	100	37 886	37 886	42 232	42 232
<b>Total</b>		<b>148 297</b>	<b>112 167</b>	<b>135 354</b>	<b>104 119</b>

Source: Ministry of Finance, own calculations (risk adjusted).

**Figure 1. General government expenditures and receipts**

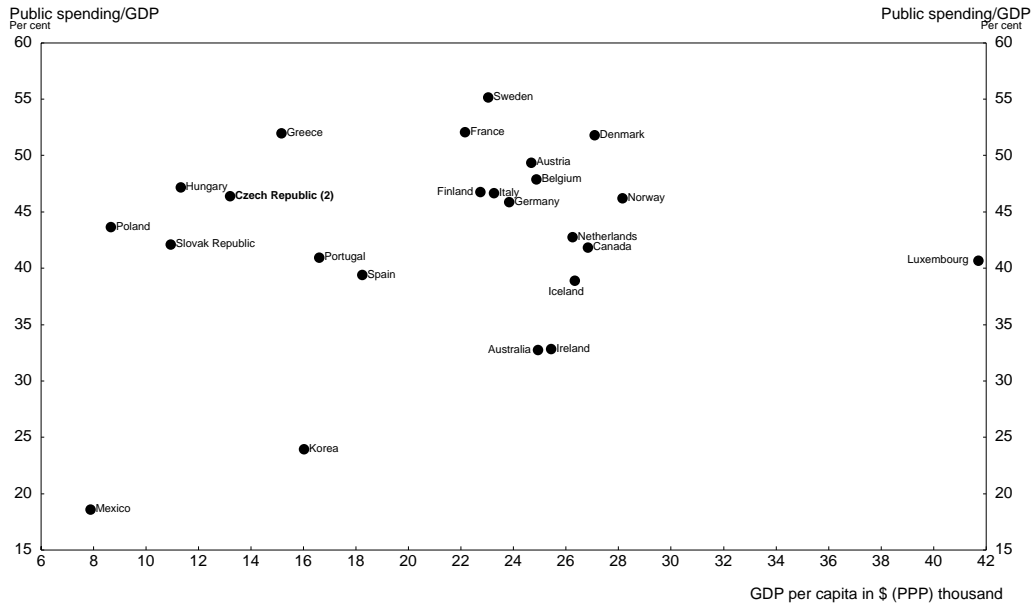


1. Estimates.

Source: OECD Economic Outlook.

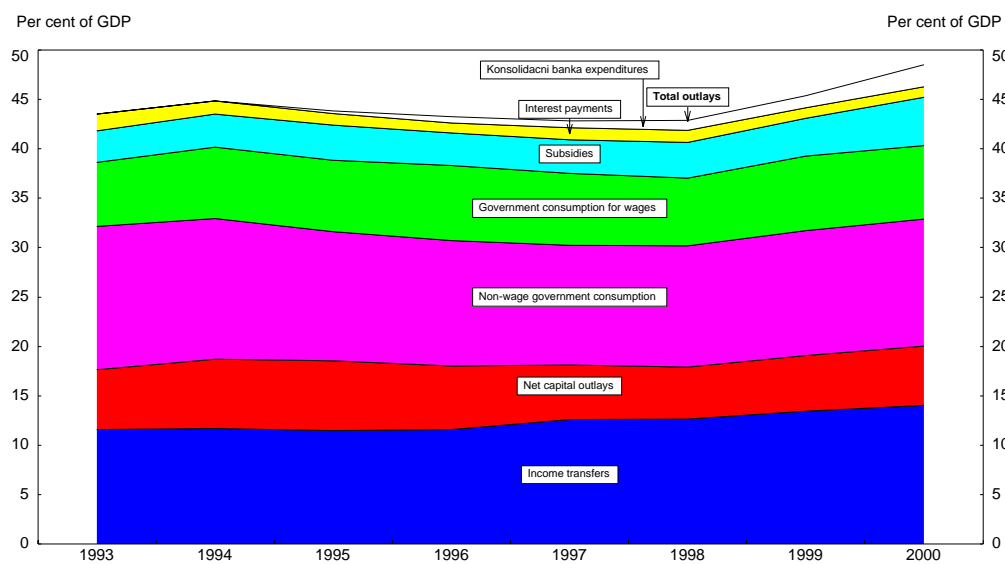
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**Figure 2. General government spending and income levels**  
1999 (1)



1. Public spending is defined as the sum of current outlays and net capital outlays. Data are based on SNA93/ESA95 except for the Czech Republic and Hungary where figures are from Government Financial Statistics (GFS) and are adjusted by the OECD to broadly match SNA93. Data for Mexico are OECD estimates.  
2. Data for the Czech Republic concern 2000.  
Source : OECD; Instituto Nacional de Estadística, Geografía e Informática (INEGI) for Mexico.

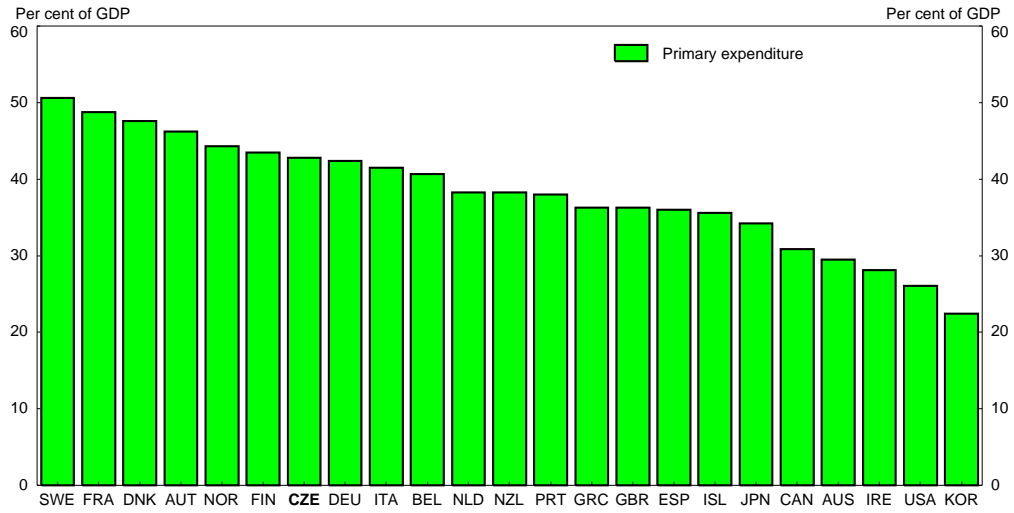
Figure 3. General government outlays by economic category



Source: OECD, revised GFS (Government Financial Statistics) accounts.

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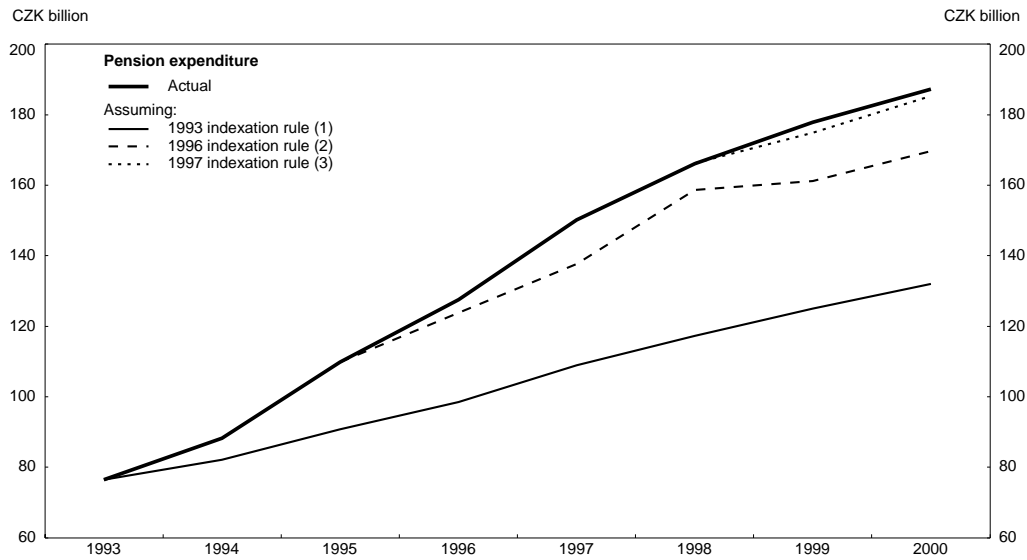
Figure 4. General government primary expenditure  
1999



Source: OECD.

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Figure 5. Pension spending under various indexation rules

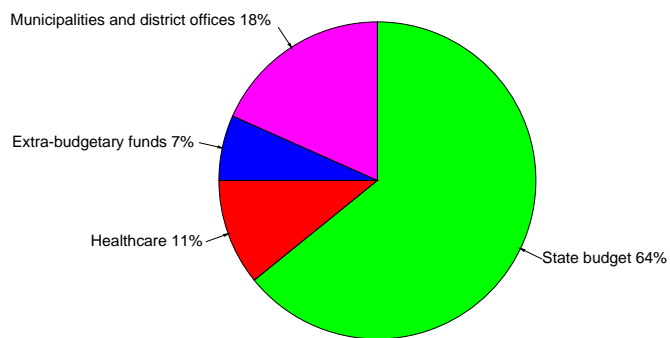


1. Indexation rule stipulated in 1991 law.
  2. Indexation rule stipulated in 1995 law.
  3. Indexation rule stipulated in 1997 law.
- Source: OECD calculations.

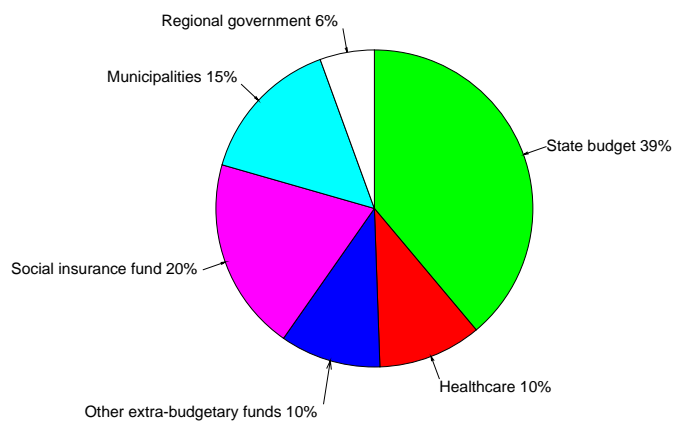
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**Figure 6. Expenditure shares in general government**

**A. Before regional reform (1)**

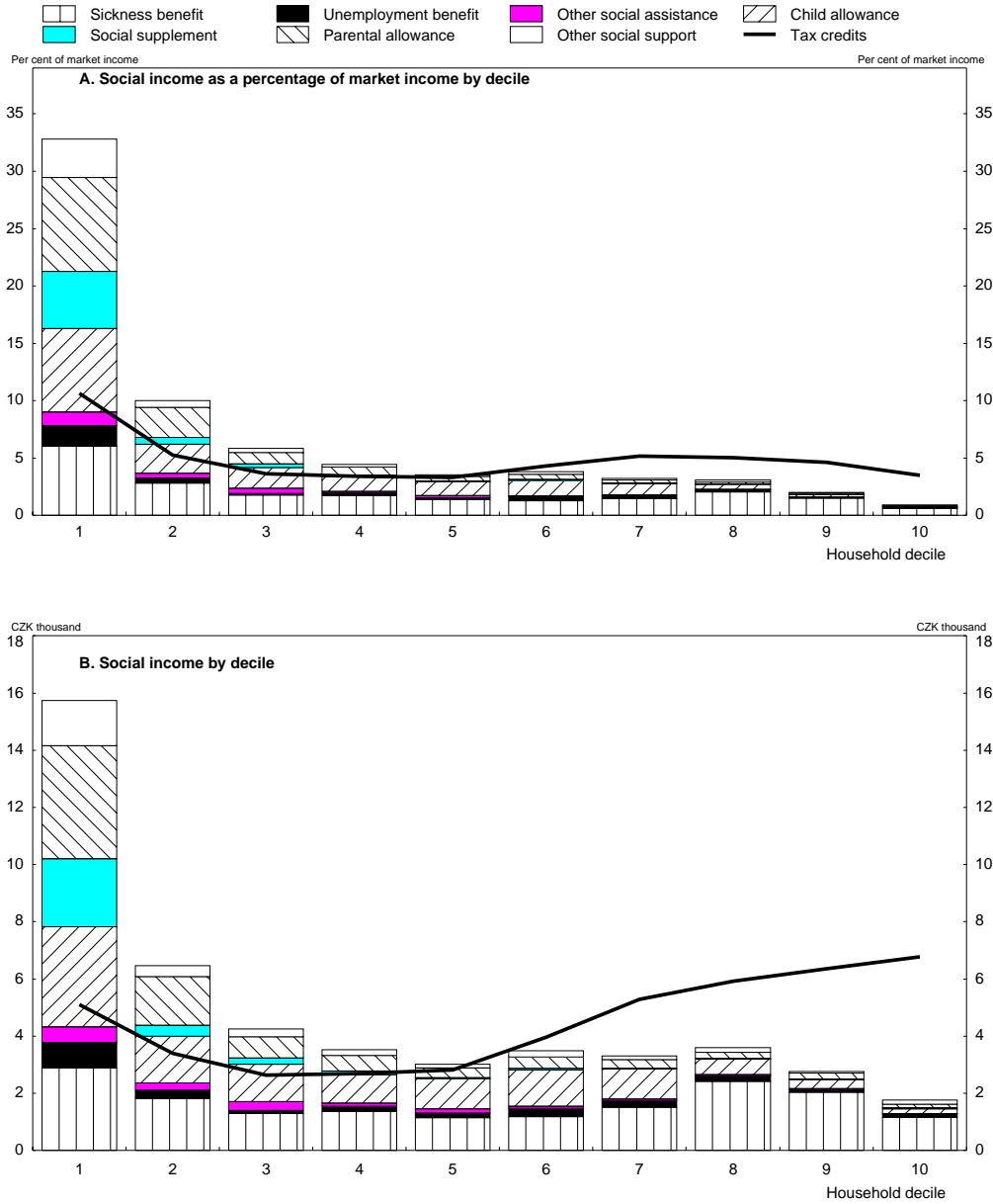


**B. After reform and creation of new extra-budgetary funds**



1. Data are based on the 2001 budget. The pre-reform panel allocates spending of the State Fund for Infrastructure and the State Housing Development Fund to the state budget. The post-reform panel includes these expenditures in the category of extra-budgetary funds. Source: OECD.

Figure 7. Social transfers and the distribution of income



Source: Schneider (2001).

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## GLOSSARY

<b>ALMP</b>	Active labour market programmes
<b>CD</b>	Czech railways
<b>CKA</b>	Czech Consolidation Agency
<b>CIT</b>	Corporate income tax
<b>CS</b>	Česká spořitelna
<b>CSO</b>	Czech Statistical Office
<b>EBRD</b>	European Bank for Reconstruction and Development
<b>EC</b>	European Commission
<b>EU</b>	European Union
<b>FDI</b>	Foreign Direct Investment
<b>FNM</b>	National Property Fund
<b>GDP</b>	Gross domestic product
<b>GFS</b>	Government Financial Statistics
<b>IPB</b>	Investiční a poštovní banka
<b>IMF</b>	International Monetary Fund
<b>KoB</b>	Konsolidační banka
<b>KB</b>	Komerční banka
<b>MLSA</b>	Ministry of Labour and Social Affairs
<b>MoF</b>	Ministry of Finance
<b>MTEF</b>	Medium-term expenditure framework
<b>PAYG</b>	Pay-as-you-go pension system
<b>PES</b>	Public Employment Service
<b>PIT</b>	Personal income tax
<b>SAO</b>	Supreme Audit Office
<b>VAT</b>	Value added tax

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## ANNEX

### GOVERNMENT ACCOUNTS

The OECD-adjusted government accounts used in this *Survey* take as a point of departure, the Ministry of Finance's consolidated general government accounts, including the state budget, extra-budgetary funds and local governments while excluding privatisation revenues which are treated as financial transactions without any direct effect on net lending. Panel A of Table A1 reports the State Budget deficit and the various additions made to it in order to arrive at the official unadjusted GFS deficit. Panel B shows the derivation of the OECD adjusted deficit and the OECD fiscal stance measure.

The OECD adjusted accounts reclassify subsidies to specialised state-owned financial institutions, *Konsolidovaná banka* (KoB), *Česká finanční* (CF) and *Česká inkasní* (CI) as part of net lending for policy purposes. This change does not affect the deficit but reduces subsidies and current expenditure.

In addition, several other adjustments are made that do affect the overall balance in individual years. First the transfers made to the various state-owned financial institutions to cover their losses over and above the subsidies mentioned above are recorded in the year after they appear on KoB's books. Generally, they are recorded on this basis within the GFS accounts but in several years their inclusion was delayed, with the effect of understating the deficit in some years and overstating it in others. In addition, the OECD adjusted accounts exclude from revenues (on the grounds that these should be classified as privatisation revenues) the CZK 31.2 billion in option sales earned by local government when they sold the rights to their shares in local power distribution systems.

In attempting to determine the fiscal stance of the government net of payments to transformation institutions, two strategies are employed. The first simply excludes all such expenditures while the second charges as an expenditure the implicit interest payments that would be paid on the liabilities of *Konsolidovaná banka* if it were included within the general government. This treatment is consistent with the approach that is to be adopted by the CSO when it revises its ESA95-based accounts.

Table A1. Components of the general government deficit and various deficit definitions

	State budget and state financial assets	Central extra- budgetary accounts <sup>1</sup>	Health funds	Central government	Local government	KoB and related subsidiaries <sup>2</sup>	Privatisation revenues	Consolidated <sup>3</sup> general government (excluding privatisation)
	1	2	3	4=1+2+3	5	6	7	8=4+5-7
<b>A. The official general government deficit</b>								
1993	0.5	1.4	0.5	2.3	0.2	0.0	2.5	0.0
1994	1.2	-0.3	-0.2	0.8	0.0	0.0	2.7	-1.9
1995	-0.2	0.9	-0.3	0.3	-0.2	0.2	2.0	-1.6
1996	-0.3	0.6	-0.2	0.	-0.5	0.7	1.6	-1.9
1997	-1.0	0.0	-0.1	-1.1	-0.3	0.7	0.8	-2.0
1998	-1.4	-0.2	-0.1	-1.7	0.1	1.0	0.9	-2.4
1999	-1.9	0.1	0.1	-1.6	1.0	0.4	1.4	-2.0
2000	-2.7	-0.5	0.1	-3.1	-0.1	1.1	1.1	-4.4
2001	-4.8	4.0	0.1	-0.7	-0.4	5.1	8.4	-9.4
	Consolidated general government (excluding privatisation)	KoB related subsidiaries as reported in GFS	KoB related subsidiaries, adjusted <sup>4</sup>	Option sales	Imputed interest on KoB liabilities	OECD deficit (excluding KoB)	OECD deficit (including adjusted KoB losses)	OECD deficit excluding KoB, including imputed interest and CI)
	1	2	3	4	5	6=1+2-4	7=6-3=1+2-3-4	8=6-5=1+2-4-5
<b>B. The OECD general government deficit</b>								
1993	0.0	0.0	0.0	0.0	0.8	0.0	0.0	-0.8
1994	-1.9	0.0	0.0	0.0	0.6	-1.9	-1.9	-2.5
1995	-1.6	0.2	0.2	0.0	0.5	-1.4	-1.6	-2.2
1996	-1.9	0.7	0.7	0.0	0.5	-1.3	-1.9	-2.4
1997	-2.0	0.7	0.7	0.0	0.5	-1.4	-2.0	-2.2
1998	-2.4	1.0	1.0	0.0	0.6	-1.4	-2.4	-2.3
1999	-2.0	0.4	1.2	1.3	0.4	-2.8	-4.0	-3.6
2000	-4.4	1.1	2.2	0.3	0.5	-3.6	-5.8	-4.3
2001	-9.4	5.1	3.3	0.2	0.9	-4.5	-7.8	-5.7

1. Includes State Funds, National Property Fund (FNM) and Czech Land Fund.
2. The column includes losses of *Konsolidovaná banka* (KoB) paid from State Budget and State Financial Assets, transfers from FNM to *eská finanční* (via KoB), *eská inkasní* (CI) and KoB (losses ensuing from takeover of bad assets of privatised banks).
3. Columns may not sum to the total because of consolidation.
4. The column reports KoB losses paid from State Budget and State Financial Assets in the year following the year when losses were accrued.

Source: OECD.

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