The Role of the Institute of Fiscal Constitution in the System of Public Budgets in the Czech Republic

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Abstract: - In the long run, public budgets in a great majority of developed economies suffer from recurring deficits and an increasing public debt. However, the condition of public finance deteriorated even in times of economic conjuncture, so the onset of the crisis in 2008 caught most of the developed world without financial reserves, or the so-called fiscal cushion. Thus most EU countries now fail to fulfill both the Maastricht Convergence Criteria and the Fiscal Compact Treaty, even if these are binding legal norms of the EU. Despite this, some EU countries voluntarily accepted a sort of financial debt cap, which the government of the Czech Republic accepted in February 2015 in the form of the so-called financial constitution, which contains a whole range of mechanisms at all levels of public budgets and public expenditures with a public debt in the amount of 55% of the GDP. The goal of this contribution is to analyze the content of the financial constitution, assess its structure and the aspects of its process application, and through selected public budgets also its possible influence on the whole economy. The content of the financial constitution shall also be compared to similar mechanisms abroad, especially in the neighboring countries.

Keywords: - financial constitution, public budgets, public finance, deficit, GDP.

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1. Long-term sustainability of public finance

A great many developed economies within the EU annually suffer from chronically repeated deficit of public finance resulting in an increasing public debt. The costs related to servicing such debts have brought some countries to the verge of bankruptcy, and only international loans provided by the European Commission and the International Monetary Fund, or the use of resources of the European Stabilization Fund saved them from going bankrupt. The increase of public debt measured by its debt-to-GDP ratio also concerns the Czech Republic, even though in comparison to most EU countries the Czech Republic shows only a small debt.

The admission of a member country of the EU into the eurozone is, besides the compliance of legal regulations of the given country with Articles 130 and 131 of the Treaty on the Functioning of the EU and the Status of the European System of Central Banks and the European Central Bank (ECB), conditioned by the achievement of a high degree of sustainable convergence. The degree of sustainable convergence is assessed in compliance with the Maastricht Convergence Criteria. These include HICP inflation (price stability), government budget deficit (long-term sustainability of public finance), government debt-to-GDP ratio, exchange rate stability, and long-term interest rates. These criteria are mentioned in Article 140 of the Treaty, and specified further in Protocol 13 on the Convergence Criteria added to the Treaty. Besides three criteria which are mainly focused on the area of currency policy, the crucial criterion is long-term sustainability of public finance[1].

The criterion of a long-term sustainability of public finance means that the given country is not subject to the decision on an excessive budget deficit. The criterion has two parts[2]:

- **The criterion of public deficit** means that the ratio of planned or real deficit of public finance to the gross domestic product in market prices shall not exceed 3% except those cases when the ratio has

[1] MF ČR, *Vyhodnocení plnění maastrichtských konvergenčních kritérii a stupně ekonomické sladěnosti ČR s eurozónou – 2014*, [cit. 19.3.2015]. Available at: http://www.mfcr.cz/cs/zahranicni-sektor/monitoring/maastrichtska-kriteria-a-sladenost-cr/2014/vyhodnoceni-plneni-maastrichtskych-konve-19965

[2] ČNB, Kritéria konvergence, [cit. 19.3.2015]. Available at: http://www.cnb.cz/cs/o_cnb/mezinarodni_vztahy/cr_eu_integrace/eu_integrace_04.html

either dropped significantly or continued dropping to a level close to the reference value, or its having exceeded the reference value was only exceptional and temporary, and the ratio remains close to the reference value. Public deficit means a deficit related to the central government including regional and local authorities and social security funds, with the exception of commercial operations defined in the European system of macroeconomic accounts,

- **The criterion of public debt** means that the ratio of public debt in market prices to the gross domestic product shall not exceed 60% except those cases when the ratio is adequately decreasing and approaching the reference value. Public debt means the gross sum of debts in nominal values at year's end, consolidated within and between individual branches of the state sector.

The criterion of the condition of public finance sets the conditions for maximum amount of the total deficit and debt of the government institutions sector. Currently, the Czech Republic is meeting this criterion. Failing to meet this criterion results for all member states of the EU in taking up the excessive deficit procedure (*Excessive Deficit Procedure, EDP*), in which the Czech Republic found itself between December 2009 and June 2014. The current goal of the fiscal policy of the Czech government (see Government Policy Statement) is to continue meeting this Maastricht criterion in the future. To be more specific – the government's fiscal strategy approaches a deficit of 2.2% of the GDP in 2015, 1.4% in 2016 and 1.1% in 2017. The main risk for this development is the not yet stable situation in the eurozone and its possible impact on the economic development of the Czech Republic.

The so-called Fiscal Pact was accepted together with the Maastricht criteria in 2012, which is an intergovernmental treaty of 25 countries of the EU on a legally enforceable stricter budget discipline of the signatories. Its full name is the “Treaty on Stability, Coordination, and Governance in the Economic and Monetary Union”. The pact was meant to save the euro which suffers from an imbalanced combination of a united monetary policy controlled by the European Central Bank and independent fiscal (budget) policies which are controlled by individual countries.

The main goal of the Fiscal Pact is the requirement for the annual structural deficit not to exceed .5% of the GDP. Countries with a debt significantly lower than 60% of the GDP, which is the case of the Czech Republic, may have a deficit of up to one percent. This rule, also referred to as the debt brake, shall be introduced into the national constitutions or laws.

The ratio of the government debt to the GDP in the Czech Republic has always been under 60%. Thanks to a relatively small government debt in the past the Czech Republic has not had problems meeting this indicator, even if its debt had increased significantly between 2009 and 2012. The debt in 2014 is expected to be 43.8% of the GDP, i.e. 2.0% lower than in 2013. The decrease of the relative level of debt is caused by a gradual dissolution of financial reserves created in the previous years, and sharing liquidity of public subjects. In the mid-range horizon the relative level of government debt should continue to drop slowly until it reaches the level of 41.7% of the GDP by 2017. Long-term risks for the future development are mainly posed by expected negative impacts of aging of the population. If there are no structural changes in the pension and health care systems, it will be necessary to count with a further increase of the debt-to-GDP ratio in the long run. The following table shows the development and prediction of fulfillment of the criterion of long-term sustainability of public finance in the Czech Republic:

Table 1: Fulfillment of the criterion of long-term sustainability of public finance in the Czech Republic 2011 – 2017

	2011	2012	2013	2014	2015	2016	2017
Balance of the sector of government institutions							
Value of criterion	-3.0	-3.0	-3.0	-3.0	-3.0	-3.0	-3.0
Czech Republic	-2.9	-4.0	-1.3	-1.5	-2.2	-1.4	-1.1
Debt of the sector of government institutions							
Value of criterion	60.0	60.0	60.0	60.0	60.0	60.0	60.0
Czech Republic	41.0	45.5	45.7	43.8	42.3	42.1	41.7

Source: ČSÚ[3] and MF ČR[4]

2 Proposal of Financial Constitution

The concept of financial constitution is by no means something completely new. A form of debt brake has been discussed in the Czech Republic for several years, and that with a much lower public debt-to-GDP ratio. In February 2015 the government passed a constitutional bill on budget responsibility and bill on the rules of budget responsibility, and also passed a bill changing some laws related to accepting legal regulations concerning budget responsibility. However, passing the act on budget responsibility will not be easy since it is a constitutional act, which has to be passed by a qualified majority, which means five fifths of all deputies and at the same time five fifths of present senators. The president cannot veto this bill.

The Act on the Rules of Budget Responsibility is a general legal regulation to further regulations in the budget area, which is why it only contains basic requirements, which are further specified by a special legal regulation, e.g. the Act on Budget Rules of Regional Budgets, or the Act on Departmental, Area, Company, or Other Insurance Companies.

From the viewpoint of practical budget-fiscal measures at all levels of public budgets, the most important is § 13 of the bill. On reaching a debt of at least 55% of the nominal GDP in compliance with Article 4 of the Constitution Act on Budget Responsibility dealing with the way how public institutions should proceed while enforcing these measures[5]:

- The government shall pass and submit to the Chamber of Deputies a proposal for a medium-term outlook of the state budget and state funds' budgets, which lead to a sustainable condition of public finance; in case the state budget bill or state fund budget bill are submitted without actually fulfilling this condition, the government shall withdraw such a bill and immediately submit a new one,
- The government shall submit to the Chamber of Deputies proposals of balanced budgets of health insurance companies; deficit proposals can only be submitted in case that the deficit could be paid using no more than 1/3 of the financial balance of a particular insurance company from the past, or using a returnable financial aid,
- A local government unit (LGU) shall pass their budget for the coming year as balanced or surplus budget; the budget of an LGU can only be passed as a deficit one if it is possible to pay the deficit using financial means from the previous years or using a returnable financial aid. Using a contractually secured loan, credit or revenue from selling municipal bonds of the LGU is only possible to pay a deficit arising from pre-financing projects co-financed from the EU budget,
- Public institutions which were not mentioned above must not, for a period during which the debt represents at least 55% of the gross domestic product, establish new contractual commitments except commitments regarding projects co-financed from the EU budget or commitments necessary to fulfill a court verdict or a public authority decision, leading to an increase of the debt of the sector of public institutions for a longer period than one calendar year.

New regulations shall pertain to the whole sector of public institutions, which in the Czech Republic includes approximately 17,500 subjects of public administration. It means:

- Organizational units of the state (283),
- State-funded organizations (123),
- State funds (6),
- Public research institutions (67),
- Public colleges (26),
- Public health insurance companies (7),
- Basic and higher local government units (6,247 + 14),
- Organizations funded by local government units (9,819),
- Voluntary unions of municipalities, so-called micro-regions (735),
- Regional territorial units - NUTS II (7),

[3] ČSÚ, *Hlavní agregáty sektoru vládních institucí*, [cit. 21.3.2015]. Available at: http://apl.czso.cz/pll/rocenka/rocenkavyber.gov_a?mylang=CZ

[4] MF ČR, *Fiskální výhled ČR (listopad 2014),* [cit. 22.3.2015]. Available at: http://mfcr.cz/assets/cs/media/makro-fiskalni-vyhled_2014-Q4_Fiskalni-vyhled-listopad-2015.pdf

[5] Compare Moderní obec, *„Finanční ústava“ se začíná rýsovat,* [cit. 24.3.2015]. Available at: http://moderniobec.cz/financni-ustava-se-zacina-rysovat/

- Corporate entities founded and financed by a public institution or controlled by a public institution entitled to nominate or remove its managers.

At the same time the salary base for the calculation of salaries of constitutional officials should decrease by one fifth, and there will be no funds for the remuneration in the sector of public institutions. The government shall also be allowed to decide on a lower increase of pensions being paid than as stipulated by law. The proposal of the department also counts on establishing a three-member National Budget Council. Its goal will be to evaluate the fulfillment of budget goals, monitor the economy of public institutions, and prepare a report on the sustainability of public finance. Besides this, there should be a seven-member Committee for Budget Prognoses which should evaluate the prognoses of the Treasury Department.

These regulations shall not apply in the following instances:

- In case of a serious worsening of the economic development for the duration of 24 months from the first day of the calendar month following the calendar month during which the Czech Statistical Authority in its quarterly national budgets publishes an inter-quarterly decrease of the gross domestic product, taking into account price-related and seasonal influences and the number of workdays in the last quarter, by at least two percent, or an inter-yearly decrease of the gross domestic product taking into account price-related influences in the last quarter by at least three percent,
- In case of an emergency, threat to the state, or state of war,
- For the duration of emergency measures declared by the government in order to increase the defenses of the state in case of a worsening of the state's defenses, or
- For a period of 24 months from the first day of the calendar month following the calendar month during which the department publishes the fact that the sum of the necessary expenditures of the state budget to remove the effects of a natural disaster which affected the territory of the Czech Republic and the expenditures resulting from the fulfillment of international treaties and other international commitments of the Czech Republic has exceeded three percent of the nominal gross domestic product.

3 Debt Brake for Municipalities and Regions

With special emphasis, the Act on Budget Responsibility deals with the economy of local government units, stipulating their basic form in § 19 of this act:

1. Shall the debt of a local government unit exceed 60% of its average income in the previous 4 budget years as of the balance date, such a local government unit shall be obliged to decrease this debt in the next calendar year by at least 5% of the difference between its debt and 60% of its revenue in the previous 4 budget years,
2. Shall the local government unit not decrease its debt, and its debt as of the next balance date exceeds 60% of its average revenues in the previous 4 budget years, the (Treasury) Department shall in the next calendar year decide in compliance with the Act on Budgetary Rules and Changes on suspending the transfer of its share in tax revenue,
3. The revenues of local government units for the purpose of this act are understood to be the sum of all monetary payments accepted into the budget in the given fiscal year, consolidated in compliance with a different regulation,
4. A debt of a local government unit for the purpose of this act is understood to be the value of unpaid obligations ensuing from issued bonds, accepted credits, loans and returnable financial aids, realization of fulfillment ensuing from pledges and issued bills of exchange.

As of December 31, 2013 92% of Czech municipalities had fulfilled the above-mentioned debt rule, i.e. they had a debt of up to 60% of their average revenue in the previous four budget years. As of the same date approximately 500 municipalities, i.e. 8% of the total number, had exceeded this limit. Only 198 municipalities (3.2%) had exceeded 100% of their average revenue in four budget years. Over 84% of the municipalities in question had a pledge on shared taxes of less than 5% of their total revenue, and in case of 93% of municipalities it should be less than 10% of their revenues. Almost 80% of those municipalities whose ratio of suspended tax revenue against the total revenue would exceed 10% would be able to finance this debt by means of the balance in their accounts, and over a half of them even for one or more election terms.

Higher local government units – regions – are a bit better off. As of the above-mentioned date none of them had breached this rule, with the average debt indicator showing 19.99%[6].

4 Mechanisms of the Debt Brake in Selected Countries

Certain forms of the debt brake are implemented in most countries of the EU. They were mostly accepted as prevention against a country's falling into a debt spiral, using a loan to pay off another, and thus facing the imminent risk of government bankruptcy, which some southern countries of the EU have in fact been through.

Slovakia

Slovakia has had a cap against a dangerous increase of indebtedness since March 1, 2012. The Constitutional Act has four main provisions: constitutional limitation of the public debt with a cap of 60% of the GDP, the establishment of the Council for Budget Responsibility, rules for transparency of public finance, and rules and limitations for the economy of local governments.

Shall the debt exceed 50% of the GDP, sanctions will be triggered and intensify with every increase. At 50% debt the Treasury Secretary must explain the reasons for it and propose measures to change it. At 53%, a package of measures is accepted and government salaries are frozen. At 55%, an automatic 3% expenditures freeze for the next year takes effect (except for European funds).

At 57%, the government shall propose a bill for a balanced budget, and on reaching the cap, i.e. 60% indebtedness, the government shall ask the parliament for confidence. The Council for Budget Responsibility shall have three members for seven years, whose mandate shall not be extendable. They shall be assisted by a team of analysts. This law creates mechanisms and tools for the prevention of indebtedness.

The rules of economy of local governments were reached through compromises. The government gave up a tax mix, thus the state shall not save the local governments in case of insolvency, but shall ensure financial means during the transfer of new competencies. A penalty has been implemented for those local governments which exceed a 60% debt of their normal revenue from the previous year, which is a provision similar to a provision which will also be effective in the Czech Republic in the future. An audit shall be performed in the whole public service to find out what kind of competencies local governments have and how they are secured. The state shall not transfer competencies to local governments without adequate funding.

Spain

Spain was the first state in the eurozone to implement the institute of debt brake. In September 2011 Spain introduced limits of budget deficit and public debt into the constitution. Spanish amendments to the constitution do not contain any exact limits as it is in Slovakia. However, an implementation act, which shall take effect in 2020, is a part of it. This act sets the cap of budget deficit at .4% of the GDP and sets criteria for gradual decreasing of the debt. The debt volume in relation to the GDP must not, according to constitutional norm, exceed the Maastricht criteria set for the eurozone countries, according to which public debt, as the sum of the state debt and debts of local governments, must not exceed 60% of the GDP, and the budget deficit must not exceed 3% of the GDP. Spain expected that by accepting this golden rule of budget stability it would appease skeptical financial markets. The state debt in the year of accepting this amendment reached almost 69% of the GDP and the budget deficit approached 6%[7].

Switzerland

The Swiss debt brake is a rule which restricts expenditures in order not to exceed the volume of structurally modified budget revenues. It means that expenditures must respect revenues, but not in the strict sense of annual balance. The Swiss federal budget may be adopted even with a deficit. There is no verisimilitude to the Maastricht criteria for maximum deficit: theoretically, its volume can be as large as they wish.

However, expenditures must respect the trend of revenue development. Expenditures of the federal government have a cap which is calculated as the function of budget revenues and the current position of the economy in the course of the economic cycle according to the following simple formula:

*Expenditures = Revenues * K,*

Where

[6] RYŠAVÝ, I. (2015) „Finanční ústava“ se začíná rýsovat, *Moderní obec*, 3: 2015, s. 10

[7] EUROSKOP, *Španělsko chystá dluhovou brzdu*, [cit. 27.3.2015]. Available at: https://www.euroskop.cz/8953/19506/spanelsko-chysta-dluhovou-brzdu

$K = Z / Y,$

Z = trend of the gross domestic product,
Y = current value of the gross domestic product.

Thus if coefficient K is greater than 1, it means that the economy is below its potential, thus it is possible to allow expenditures greater than revenues. On the contrary, if the economy is “overheated” and $K < 1$, a surplus budget is required.

The goal is to keep the total expenditures of the federal government relatively independent of the economic cycle, thus the growth of expenditures reflected the trend, long-term growth of the economy. Tax revenues shall fluctuate depending on the economic cycle, which means that it is not necessary to raise taxes in the period of recession and thus deepen it. So the Swiss debt brake is not procyclic, as it does not worsen the course of a recession. On the contrary, it helps balance recessions in the spirit of Keynes' teaching. However, shall the government follow the traditional orthodox policy of balanced budgets in every budget year, the debt brake will not rule this policy out.

The Swiss implementation regulation regarding the debt brake also works with a compensation account which adds the values of deficits and surpluses once the final balance for the particular year is known. Deficits in this account must be taken into account while calculating a new expenditure cap for the coming years. If the deficit exceeds six percent of the expenditures, the surplus amount must be eliminated during the nearest three annual budgets by decreasing the expenditure caps.

We need to note that the Swiss federal budget does not distinguish standard and investment expenditures in terms of the total expenditure cap. This is intentional since it is not possible to simply claim that macro-economically speaking standard expenditures are “bad” while investment expenditures are “good”. Any kind of investment in infrastructure regardless of future usefulness does not have to be better than standard expenditures on salaries or the running of the country[8].

The complete text of the Swiss debt brake is found in Article 126 of the Swiss Confederation:

1. *The Confederation shall keep its revenues and expenditures balanced in the course of time.*
2. *The cap for total expenditures, which is supposed to be passed within the budget, is based on expected revenues considering the economic situation.*
3. *Exceptional financial requirements may substantiate an adequate increase of the cap as stipulated in Paragraph 2. The Federal Assembly shall decide on every cap increase by an absolute majority of all (not only present) votes.*
4. *If the total expenditures of the federal budget exceed the cap as stipulated in paragraphs 2 or 3, it will be necessary to compensate for these expenditures by savings.*
5. *Details are to be stipulated by law.*

The Swiss debt brake was first applied relatively recently – as late as 2003. While being used, it succeeded to decrease the growth of public expenditures from an average 4.3% to 2.6%, and the total Swiss state debt decreased from 53% of the GDP to 36.5% of the GDP[9].

Poland

The Polish Constitution, effective since October 1997, stipulates such a provision, which makes the government take measures in case that the public debt reaches 55% of the GDP. Shall the debt reach 60% of the GDP, the constitution forbids the government to render loans and state guarantees, and thus further indebt the country.

This relatively less developed country has been experiencing a constant economic growth for over two decades, and is the only economy of the EU that avoided a deeper recession during the financial crisis.

[8] GEIER, A. (2011) The Debt brake – the Swiss fiscal rule at the federal level, *Working Paper of FFA No 15*.

[9] KOHOUT, P. *Nová ústava - Jak funguje švýcarská dluhová brzda*, [cit. 27.3.2015]. Available at: http://www.novaustava.cz/clanky/jak-funguje-svycarska-dluhova-brzda

A 17-year tradition of constitution-embedded anti-debt rules also probably contributes to the fact that Poland strongly supports German requirements of budget discipline and savings. The constitutional restriction of future indebtedness of both Germany and its states was passed by the German parliament in June 2009. The states will not be allowed to create new debts starting 2020, and only a deficit up to .35% of the GDP will be allowed starting 2016.

5 Conclusion

The need to introduce debt brakes throughout the member states of the EU ensues from the wording of the Fiscal Pact, which adds to the Maastricht Convergence Criteria the limit of the structural deficit of public finance, and which has been adopted by 25 states of the EU including the Czech Republic as of today. However, it will become a legally binding norm for the Czech Republic only after its entering the eurozone. The institute of debt brake, or the fiscal constitution, has been adopted by the individual countries voluntarily, since the condition of public budgets of most countries of the EU is not sustainable in the long run, and the need for fiscal correlation toward public debts is clear and objective, and is the subject of societal consensus.

Taking into account the fact that in case of the Czech Republic it is just the first proposal of a fiscal constitution, or debt brake, and might eventually become effective as of January 1, 2016, the Czech Republic will not be among the first countries to have adopted it in their legal system. However, its content is fully comparable to similar institutes abroad. The financial constitution of the Czech Republic respects the limit for long-term sustainability of public finance, mainly the limit of the state debt in the amount of 60% of the GDP. Thus it takes effect with the public debt reaching 55% of the GDP in order to have enough time to adjust the development of public budgets and public finance. The financial constitution also concerns basically all levels of public budgets, not only the state budget, but also the budgets of local governments, i.e. budget of local government units, even if those periodically show better fiscal condition than the state budget.

An inseparable question while discussing the concept of fiscal constitution are also wider issues of the macro-economic development. This concerns not only the nominal amount of deficits and the public debt, but their relative relation in respect to the GDP. It is namely this economic recovery and the growth of the GDP which lead to a better tax revenue of the state, a more favorable debt service, a smaller demand for public budgets, lower unemployment, and other positive impacts on the economy of the civil service and local governments.

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[3] EUROSKOP, Španělsko chystá dluhovou brzdu, [online]. cit. 2015-3-27. Available at: https://www.euroskop.cz/8953/19506/spanelsko-chysta-dluhovou-brzdu

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