

Office of the Czech Fiscal Council

CZECH FISCAL COUNCIL

OPINION

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on general government finances and fiscal and budgetary policy

Pursuant to Section 21(2)(a) of Act No. 23/2017 Coll., on the Rules of Budgetary Responsibility, as amended, the Czech Fiscal Council monitors general government finances. As part of that work, it also strives to identify risks and threats that may have an adverse impact on public budget stability in the short, medium and long term. The Czech Fiscal Council has informed the public about its conclusions every quarter since September 2018.

Initial economic situation

Czech gross domestic product rose by 2.4% on a year-on-year basis in 2022. The main driver of this growth was gross fixed capital formation, which grew by 6.2%, while household consumption fell by 0.9% because of a decrease in real wages of 7.5% (y/y) caused by high inflation. The Czech economy found itself in technical recession in 4Q 2022. After a real decline of 0.3% q/q in 3Q, there was a drop of 0.2% q/q in 4Q. In 4Q, the final consumption expenditure of households decreased by 5.5% (y/y), with expenditure on food recording a particularly significant slump of 10% (y/y). Sales in services meanwhile decreased by 0.8% q/q, mainly due to lower sales in transport and storage. Retail sales dropped by 8.7% (y/y) in 4Q.

The economy thus entered the expected downturn at the end of the year. The labour market meanwhile remains relatively tight, as unemployment is still very low. According to the Ministry of Labour and Social Affairs, the share of unemployed persons rose from 3.7% to 3.9% in January. According to the CZSO Labour Force Survey, the unemployment rate was 2.6% in January. However, industrial companies expect a sizeable decrease in the rate of growth of their production and lower employment. Their confidence in the economy fell in February to the lowest level since June 2020. By contrast, consumer confidence increased sharply for the second time in a row in February. Nevertheless, it remains far below its long-term average. For the first time since April 2018, the number of registered job seekers exceeded the number of vacancies in January 2023.

The economy is suffering from significant and historically unique imbalances, both internal (high and not yet declining inflation) and external (a significant current account deficit). In 2022, the trade balance was negative for the first time since 2003 (CZK 8.3 billion). This was mainly due to high import prices of energy commodities. This fact, together with a record-high primary income deficit (-4.9% of GDP), caused a historically unusual strong decline in the current account to -5.6% of GDP. The inflation rate reached 15.1% in 2022. In January 2023, the consumer price index stood at 17.5% (y/y), but

excluding imputed rent inflation would have been 18.7% (y/y). In January, core inflation declined to 12.3% (y/y), the lowest level since March 2022. This is due to imputed rent, which slowed to 9.1% (y/y), reflecting a cooling of the property market. Prices of apartments dropped by 0.7% (q/q) in 4Q, the first decrease since 2013. The consumer price index on a month-on-month basis reached an all-time high of 6.0% in January. This was mainly due to a change in methodology in December 2022, with the CZSO accounting for government measures such as a waiver of fees for renewables and a one-off household electricity allowance.

General government finances and fiscal policy for the coming years

According to the estimates of the Ministry of Finance of the Czech Republic,¹ the general government balance ended better than initially projected in 2022 (-3.6% of GDP instead of -4.6% of GDP). This was mainly due to lower-than-planned compensation payments to large firms for high energy prices, lower social transfers, higher surpluses of municipalities and regions, and faster settlement of claims of the Financial Market Guarantee System arising from the insolvency of Sberbank. The estimate of the structural deficit is also currently slightly more favourable (2.6% of GDP) than it was in the past, but the figure remains high.

After two months, there is still very limited information available for assessing and forecasting this year's performance of the general government sector. The Ministry of Finance expects a deficit of 4.2% of GDP this year, while the CNB expects a deficit of 4.5% of GDP.

The most important component of the public finances – the state budget – showed a relatively high deficit of CZK 119.7 billion in cash terms for the period January–February 2023. However, this figure is partly distorted by the pre-financing of some expenditure headings, and a correct evaluation of the situation requires a look at the dynamics of the most important expenditure and revenue items.

The expenditure side as a whole has not yet deviated significantly from the budget aliquot for the first two months (16.4% vs. 16.7%). Personal income tax and social security contributions – the most important revenues – are showing good dynamics. On the other hand, VAT and some selective excise duties are slower. The evolution of corporate income tax cannot be correctly assessed yet given the quarterly frequency of that payment.

The overall performance in 2023, or the deviation from the approved balance of the state budget, will be significantly affected by the balance of revenue and expenditure resulting from interventions in the energy supply market. The dynamics of expenditure on compensation payments to providers is relatively high (about CZK 7.5 billion per month), but these are so far only advance payments. On the revenue side, levies on excess income from electricity producers amounted to CZK 5.7 billion, which is the sum of the payments for December 2022 and January 2023.² The income from advance windfall tax payments will not be known until the second half of this year. Based on the above information, it is therefore very difficult to judge the overall balance of all the measures at this time, despite the better situation on energy markets.

¹ MFČR (2023): Makroekonomická predikce – leden 2023

² This amount will be credited to the state budget in March.

Another risk in the direction of a higher-than-approved deficit is expenditure on extraordinary pension indexation (at either the original or reduced level). Moreover, its final form will have a very significant impact on budgets in future years.³

Although the February deficit should be assessed with caution, its size confirms the significant imbalance in the Czech public finances. This has wider negative implications for the economy, in particular strengthening inflationary pressures.

This year needs to be one of consolidation of public budgets to move them closer to more sustainable levels. The Council considers that consolidation measures must be reflected already in the 2024 budget, preparations for which will begin in the first half of 2023. However, the Council points out that this is only a first step and further consolidation will have to take place in the following years.

The Council also points out that several proposals have emerged over the last few months which may have a significant negative impact on the systematic setting of public finances in the future. The first of these is an attempt to shift part of the deficit from the state budget to parafiscal units. There is a parliamentary proposal⁴ that would enable the State Fund for Transport Infrastructure to issue its own bonds. This proposal is related to the fact that this year's state budget subsidy does not cover all the approved expenditure items of this Fund. As the Council has already stated several times, this is an unprecedented measure which will lead to a reduction in the transparency of public finances, to higher administrative costs and (with high degree of probability) to higher interest costs on these loans. All this applies even though the parliamentary proposal contains a safeguard in the form of a requirement for Ministry of Finance approval for this off-budget financing. Moreover, due to this move, other government institutions may be interested in this type of financing.

It is also worth mentioning there are plenty of proposals for automatic indexation of various expenditure items. Already in effect is indexation of payments for those insured by the state. Then there is a proposal for automatic indexation of the care allowance and a guarantee of 130% of the average salary in the economy for all teachers in regional education. These are at various stages of approval. The Council considers this approach to be highly risky, as it reduces the manageability of public finances and limits the government's space for discretionary intervention. This system will lead to a continuation and deepening of negative trends, especially in a situation of unbalanced public finances. It may also have unexpected effects in specific macroeconomic conditions, which is exactly what happened with indexed pensions last year and this year.

Probably the most pressing problem with Czech public finances is the imbalance in the pension system, where the deficit this year exceeds CZK 70 billion, or around 1% of GDP (even with reduced extraordinary indexation). This imbalance arises despite a relatively favourable demographic structure, and its main cause is the configuration of the indexation mechanism. In a period of high inflation and falling real wages, the current mechanism leads to significant deficits in the pension account and motivates people of pre-retirement age to retire or apply for early pensions. The Council believes that the indexation mechanism (both extraordinary and regular) should be adjusted, not just on a one-off basis, but in a systemic way.

³ The reduction of the extraordinary indexation passed by the Czech Parliament means a reduction in public budget expenditure between 2023 and 2030 of around CZK 250 billion in absolute terms and around 0.36% of GDP in relative terms each year.

⁴ Sněmovní tisk č. 376. Návrh poslanců Ivana Adamce, Martina Kupky, Ondřeje Lochmana, Antonína Tesaříka, Jiřího Slavíka a Jakuba Michálka na vydání zákona, kterým se mění zákon č. 104/2000 Sb., o Státním fondu dopravní infrastruktury, ve znění pozdějších předpisů.

Given that the pension system will come under further pressure in the relatively near future due to an increase in the proportion of pensioners in the total population, the Council believes that it is necessary to make adjustments now. This cannot be done, however, without adopting unpopular measures, including a gradual increase in the retirement age above 65 and other adjustments to the pension assessment and indexation parameters which will lead to a partial reduction in replacement rates in the longer term. In addition, it is necessary to implement measures to increase labour market participation, including limiting the possibility of early retirement. However, these changes must be accompanied by a significant adjustment of Pillar III, which has to compensate (at least partially) for the above-mentioned decline in the replacement rate in the future.

The current design of Pillar III is largely dysfunctional, as no increase is occurring in the number of people using their savings as a regular additional source of income during retirement, despite the high costs the government bears through direct and indirect support.

Unfortunately, in the Council's view, the proposals presented so far which modify Pillar III do not address the main problems (the tendency towards one-off withdrawals and the insufficient proportion of younger participants, who should save money for a significant part of their active lives). The Council considers the planned introduction of an Investment Pension Account to be exceptionally risky. In its current form, it will merely give rise to a new state-supported savings product used mostly by above-average earning households. Given that the funds can be withdrawn in a single withdrawal, the Account will have only a marginal impact on the income situation of pensioner households. Moreover, these products may not always be comparable to current state-supported products in terms of regulatory design, supervision and other key parameters.