# Office of the Czech Fiscal Council

# CZECH FISCAL COUNCIL

## OPINION

of the Czech Fiscal Council

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*Concerning the development of public sector finances and the set-up of fiscal and budgetary policy*

Pursuant to Act No. 23/2017 Coll., on budgetary responsibility rules, Section 21(2)(a), the Czech Fiscal Council monitors the development of public sector finance. Within the framework of that work, it also strives to identify risks and threats that may have an adverse impact on public budget stability in the short-term, medium-term, and long-term. Since September 2018, the Czech Fiscal Council regularly, on a quarterly basis, has informed the public about its conclusions.

**Macroeconomic background** Refined estimate of GDP released by Czech Statistical Office (CZSO) improved the estimate of the year-on-year GDP growth in Q2 2021 to 8.2%. The dominant factor in GDP growth was household consumption whose increase accelerated to 7.4%. Gross capital formation noted a significant increase, with a growth of 13%. The contribution of investment demand was significantly lower due to the fact that fixed capital formation itself increased only by 1.5%, as the growth of capital formation was driven predominantly by increases in inventory. The high accumulation of inventory is caused by a shortage of components and the materials required for the finalisation of production, and by disruptions in customer-supply chains. Both factors should be only temporary; nevertheless, a longer recovery horizon would pose a risk to future growth.

The massive, 30.6% increase in exports was accompanied by an even higher growth in imports, by 31.3%. Imports rose not only due to the continued high import intensity of exports but also due to the high import intensity of reviving investments. Overall, foreign trade made roughly a neutral contribution to annual GDP development.

The strong acceleration in exports corresponds primarily to the performance of industry. Growth of value added in the manufacturing industry rose by 23.2% year-on-year in Q2 2021. Total industrial production noted a record 33% rise, and manufacturing even a 37% rise. According to the Czech Statistical Office (CZSO), Czech industrial production in the first half of 2021 was 15% above that of a year ago, reaching pre-covid levels. New orders from abroad were up by 20.5% in June, whereas new domestic orders were up by 27.9%. Furthermore, the current August business cycle survey looks relatively positive – industrialist confidence declined slightly in August compared to July, but it is still at pre-covid levels – with industrialist confidence being at those levels, too.

Not only industrialists, but also entrepreneurs in the service sector view the situation more positively than a year ago. In line with the fact that the share of entrepreneurs who plan lay-offs is very low, consumer fears of losing their jobs have declined. The share of unemployed people in July stood at 3.7%, meaning that it was only up by 1.1 pp from its all-time low in the autumn of 2019. According to available statistics of the Ministry of Labour and Social Affairs, the imbalance between the number of vacancies (358,000) and the number of available job seekers (272,000) has been rising again This gap on the labour market will thus continue to create inflationary pressures. Consumers are therefore legitimately concerned about inflation– measured as a year-on-year increase in consumer prices– rose by 3.4 %,y/y exceeding significantly the upper limit of the target range set by the central bank.

**Public sector finances and the set-up of fiscal and budgetary policy for the coming years**

The economic development of the most important component of the public budget system – the state budget – confirms a slow-down in the growth of the deficit compared to the spring. At the end of August, the state budget showed a deficit of CZK 298 bn (net of transactions with the EU of CZK 302 bn). Month on month, it dropped by CZK 21 bn (after adjusting for transactions with the EU).

In August, in its estimate of tax and insurance revenues[1], the Ministry of Finance of the Czech Republic increased its estimates of expected revenues this year (+CZK 99 bn) and next year (+CZK 61 bn) rather significantly. One of the reasons for this step is the higher-than-expected growth in the volume of wages and salaries in the economy, which has positive effects on expected revenues from social security contribution and personal income tax from dependent activity. Also, tax payments by persons filing their own tax returns developed better than original estimates had shown, as did revenues from corporate income tax. It is becoming evident that the impact of the COVID-19 crisis on tax bases of business entities was lower than had been originally expected.

The consequence of the above is an improvement of the expected balance of public sector finances for this year from -8.8% of GDP to -7.7%. Hence, it can be assumed that government budget deficit should be lower than the approved CZK 500 billion.

The structural balance should reach -6.1% of GDP this year, compared to the originally expected -6.4% of GDP. Given that, pursuant to the current wording of the Act, structural balances in the coming years will be derived from the estimated balance for this year (an annual improvement by 0.5% of GDP), this can be viewed slightly positively. Nevertheless, the CFC warns that, if the minimal consolidation effort is maintained, the value of -1% of GDP[2] would not be reached before 2032. As in the past, the CFC believes that the rate of consolidation should be far higher, and the 1% structural balance level should be achieved far sooner. It is necessary to create room for future active fiscal policy responses and stabilise and then subsequently reduce the relative debt burden. Any negative impact of higher fiscal consolidation on economic growth will be mitigated by the relatively quick return of the economy above the potential output level.[3]

The slight improvement of expected structural balances as well as the increased nominal GDP level[4] delays the potential year of collision of the debt quota indicator with the debt brake rule (55% of GDP). Whereas past projections showed that this would take place as early as in 2024, it would currently be two to three years later. The CFC naturally sees this as positive, as it opens up a longer timeframe for consolidation efforts.

According to the performed calculations, the collision with the debt brake could be prevented in the future by a very slight increase in the annual consolidation effort, by approximately 0.15% of GDP

[1] https://www.mfcr.cz/cs/verejny-sektor/makroekonomika/vybor-pro-rozpoctove-prognozy/jednani-vyborupro-rozpoctove-prognozy

[2] The structural balance limit defined in the original text of the Act.

[3] According to the Ministry of Finance of the Czech Republic estimate in the current Macroeconomic Forecast, the Czech economy should show a positive output gap of nearly 2%. If an economy is significantly above the potential output level, fiscal multipliers decline, so the negative effects of the reducing of aggregate demand through fiscal restrictions on economic growth are limited.

[4] Due to a revision of national accounts. The consequence is a slight decrease of the debt quota (public sector debt as a percentage of GDP).

(i.e., from 0.5% of GDP to 0.65% of GDP). In order to achieve this, the CFC recommends using increased expected revenues in 2022. Unfortunately, the current version of the state budget proposal for 2022 plans on a deficit of CZK 377 bn, with the significant increase in expected revenues being offset by a further increase in expenditures. Furthermore, the chosen level of deficit means that the expenditure limit derived from the Act would be exhausted and hence that the scope of consolidation expressed as a year-on-year change in structural balance only reaches the minimal level set by the law, of 0.5% of GDP (i.e., CZK 32 bn).

Despite the slight improvement in the outlook mentioned above, the CFC continues to warn that Czech public finances are at a significant structural imbalance, which is not predominantly caused by stabilisation measures adopted in connection with the COVID-19 epidemic, but by enduring changes in the set-up of tax policies (in particular, the abolition of super-gross salary taxation, increased basic tax credit , abolition of the real estate acquisition tax)[5] and expense policies (e.g., increase of pensions above the rate set by the indexation formula). The structural balance expected in 2022 should reach -5.6% of GDP, which corresponds to CZK 360 bn. The CFC warns that this is an imbalance that is not going to be resolved by economic growth. Significant adjustments will be required both on the revenue and the expenditure sides. Unfortunately, the proposals made in the current public debate are only cosmetic, with a fiscal impact in the range of single digits, or at most tens of billions of crowns, or the proposals are very vague.[6]

In terms of the long-term sustainability of public finance, again, not even limited progress was made towards a systemic modification of the pension system, which will be put under significant pressure after 2030 due to demographic change. Partial adjustments to the system were approved in August (higher-than-statutorily-defined pension increasing in 2022, introduction of the so-called upbringing allowance, i.e., CZK 500 for every child raised, and the possibility of retiring early without a pension cut for employees from the integrated rescue system), but these work only to yet deepen the imbalance between revenues and expenditures, by approximately 0.4% of GDP from 2023. Thus, the pension system adjustments again focus on only the popular part, neglecting steps that would improve its financial sustainability. The CFC considers this to be short-sighted and believes that a change on the expenditure side should always be accompanied with a modification of other parameters that would ensure its sustainability at least in the medium term.

[5] As an illustration, we could say that if personal income tax had not been reduced significantly and the tax on the acquisition of real estate abolished, the debt quota would reach the maximum value at around 43.5% in 2025 with a minimum consolidation effort of 0.5% GDP, and then it would start to decline.

[6] For an illustration of how the main parameters of the most important taxes would have to be adjusted to achieve a significant reduction in deficit, see the "Tax Revenue Calculator" at https://unrr.cz/wpcontent/uploads/2021/09/KVP_UNRR_2021.xlsx