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 task, 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

The performance of the Czech economy in Q1 of this year was only in part influenced by the effect of the Covid-19 pandemic. GDP declined by 2% year on year, in particular due to the weakening of exports and investments, whereas household consumption stagnated. Development in the second half of the year will depend not only on the restart of the economy after the loosening of domestic measures stifling economic activity, but, above all, on the development of demand for Czech exports by our main trading partners.

At this point, relevant data is not yet available about the development of the economy in April and May, with the exception of indicators of confidence and data about the state budget. In April, confidence indicators noted a strong adverse impact, in terms of both entrepreneurs and consumers. Consumer sentiments improved in May, but entrepreneurs remain sceptical. Compared to the results of the April survey, consumers were less concerned about a worsening of the overall economic situation, their own financial situation, or an unemployment rise in the next twelve months. With a view to the development of current inflation, however, their fears of price hikes were up significantly.

Expectations among industrial firms, concerning future developments of the economic situation for the next three months, remain pessimistic, whereas, compared to April, they are more optimistic when it comes to the period of the next six months. A positive May outcome of the survey in the industrial sector is the expected development of exports in the next three months: whereas in April, nearly 40% of industrialists had expected a drop in exports, in May only 28% did. Among other things, the exchange rate of the Czech crown to the euro developed in favour of exporters, with the country's currency weakening significantly in comparison to the time prior to the arrival of the Covid-19 pandemic. Neither the weaker currency exchange rate nor the drop in CNB basic 2W repo rates to 0.25% can do much to help reverse the drop in foreign demand, given the current circumstances. Approximately one-quarter of industrialists are planning layoffs at this point, with 11.6% of them reporting financial problems related to solvency, like in 2019.

Scepticism persists in certain service sectors, in particular due to a combination of the impact of restrictive measures and the overall change in outlooks related, above all, to tourism and the tourist sector.

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

Major restrictive measures against the spread of the Covid-19 disease, which paralysed the economy, naturally involved a drop in public budget income and an increase in certain expenditures. Furthermore, a number of measures were adopted to help stabilise the economic situation of affected companies. All that resulted in a dramatic worsening of the government budget balance. At the end of May 2020, the deficit net of the impact of operations involving the EU was nearly CZK 164 bn. In the previous month, the deficit amounted to CZK 89 bn. In May, the greatest year-on-year drop in budgetary income (by 14.4%) was noted on the collection of personal income tax from dependent activity. One of the reasons is the payment of a compensation bonus that is administered as a refund of this tax. The drops in other fiscally significant taxes were lower (e.g., corporate income tax by -11.1%, VAT -6.9%), collection of social security contributions stagnated year-on-year. The expense side was burdened, aside from originally planned expenditures, by the first payments from the Antivirus programme and expenditures on the purchase of medical devices.

The Czech Fiscal Council is of the opinion that, in the present situation, government assistance to affected economic entities is necessary, even at the price of a significant increase in the public budget deficit. The Czech Republic is, fortunately, entering this period in a relatively comfortable position in terms of public debt, which as a share of GDP amounted to 30.8% at the end of 2019, whereas the EU average was 79.3%. In the case of the structural balance, the fiscal room for response was, unfortunately, significantly reduced by a pro-cyclical fiscal policy of the government in 2018 and 2019, when the government applied expansive fiscal policy at a time of very good economic growth, which resulted in a worsening of the structural balance by 1.9 p.p. (from 0.9% GDP in 2017 to -1% GDP in 2019)[1].

The overall balance of public sector finance in 2020 will depend on the extent and duration of stabilisation measures and also on the overall GDP drop, which can now be estimated only in rough terms. If the economy drops by 5.6% this year, as the MF expects in its April prediction, and if the existing scope of stabilisation measures were not increased any further, the public sector deficit would, according to CFC calculations, amount to CZK 304 bn, which would correspond to 5.5% of GDP[2]. If the prediction of the International Monetary Fund were fulfilled, which expects a drop of the Czech economy by 6.5% in 2020, the public sector deficit would deepen to 5.9% of GDP.

According to the CFC, however, the necessary loosening of public finance should only be temporary, and a stabilisation stage should be followed by a return to a sustainable trajectory. For that reason, the CFC is of the opinion that the loosening of the structural balance limits through to 2027 (approved as a part of the amendment of the Act on Budgetary Responsibility Rules) is not only desirable, but necessary. According to CFC calculations, public sector debt will reach 44% of GDP by 2025, assuming that the year-on-year drop in the economy this year will amount to 5.6% and that the government will make use of the entire fiscal space provided by the amendment of the Act on Budgetary Responsibility Rules in upcoming years.

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[1] MF CR: Macroeconomic Prediction, April 2020, p. 11.

[2] ÚNRR: Updated estimate of the impact of COVID-19 on the economic balance and on the development of public sector debt – situation as at 5 May 2020.

In terms of the effectiveness of the measures adopted in support of the economy, prevailing lack of flexibility in certain parts of public administration is, unfortunately, becoming manifest, which is, among other things, evident in the inappropriately set up system of applications in which applicants frequently err, and the slow speed of their processing.

Of the measures being implemented at this point, the CFC draws attention to the adverse impact of the compensation bonus, on municipal and regional budgets. The possibility of a retroactive application of a loss against income tax, which has already been approved by the Chamber of Deputies, would also have an adverse impact on the budgets of territorial self-governing units. This sector of public budgets has been, up to this point, very stable, and it would not be good to lose that advantage. Budgets of local government units have already been severely stricken by the cyclical outage of public budgets and any further reduction may have a very adverse impact on their investment activity, which can be considered very important in terms of scope, given that, in recent years, investments by local government units amounted to nearly one-half of all public investments. The CFC is therefore of the opinion that local budgets should be compensated for such a massive additional outage in income, by a transfer from the state budget, in the form of non-specific subsidies. If the outage were addressed by subsidy programmes linked to specific projects, the result would be an increase in administrative costs and delays, which could contribute to pro-cyclic behaviour of public investments and hence to a deepening of economic drop. Furthermore, the fiscal autonomy of local local government units would be restricted.

As concerns the change in income tax mentioned earlier, consisting of the possibility of a retroactive application of a tax loss, the CFC notes that this is an instrument with a potentially very significant impact on public budgets. Its effectiveness in terms of maintaining employment and stabilising companies is very low compared to existing tools; additionally, tax legislation would become even more complicated as a result. If this measure is indeed adopted, it will be absolutely key to put a ceiling on the maximum level of retroactively claimed loss. If this were not done, there would be a realistic threat that companies owned by foreign entities would tend to move their tax losses to the Czech Republic as a tax optimisation measure. Furthermore, it is generally appropriate for public budget assistance to be predominantly targeted towards small and medium-sized businesses which can be expected to have lesser financial reserves that large corporations.

The CFC is also of the opinion that, at present, when various measures for the stabilisation of the economy are being introduced and continue to be adapted, and when there is insufficient room for discussion about other measures, steps should not be taken that are not entirely connected to the coronavirus crisis and that have a potentially significant impact on public finance transparency and sustainability. In the former case, it is, for example, an amendment of the Public Procurement Act, where the government proposes several adaptations aiming to reduce transparency of negotiated procedure with publication and the doing away with the obligation to set up an evaluation committee for significant contracts. The CFC is of the opinion that especially in the case of negotiated procedure with publication, at least the existing minimalist procedural requirements must be retained, as it is a non-competition method with a high risk of inefficiency. Expenditures on contracts awarded through this method by public contracting entities range between CZK 12 and 20 bn[3] per year.

As for measures that may influence public sector sustainability in the future, they currently include, for example, the method of financing of the construction of additional blocks of the Dukovany power plant. Given the scope of its powers, the CFC is not about to join the debate of the Czech Republic's

[3] MRD: 2018 Annual Report on the State of Public Contracts in the Czech Republic.

energy mixture; nevertheless, it deems it important to discuss the aspects thereof that have a major impact on public budgets. In May 2020, the Government presented a proposal for the provision of a loan to ČEZ, covering up to 70% of the funding required for the completion of the Dukovany power plant, with the project costs amounting to approximately CZK 160 bn. It is evident that the state would have to secure an amount like that in capital markets, which would result of increasing public debt as a share of GDP, an indicator of the debt rule of the Act on Budgetary Responsibility Rules. Furthermore, experience from the construction of nuclear power plants abroad in recent years have shown that budgeted amounts are regularly significantly exceeded. The fiscal costs of the completion of the power plant may in the end be significantly higher than present estimates show. Hence, the CFC is of the opinion that decisions of similar importance should be made subject to careful analysis and detailed discussion.

Given the gradual improvement of the epidemiological situation and return of the economy to normal, the CFC is also of the opinion that the discussion should be renewed of the regulation of the main expense areas that will be under major pressure in connection with changes in demographic structure. These include, above all, the pension and long-term care systems.