Office 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 (CFC) 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.

Basic economic situation

The performance of the Czech economy, measured by GDP, accelerated to 4.8% in Q1 2022 (even though the comparison is with the relatively low baseline of 2021). Growth was supported primarily by household consumption, which was up by 8.5% year on year. Inventories began to translate into investments, the year-on-year growth in gross fixed capital production being 7.4%. Foreign trade remained the weak point of the Czech economy in Q1 2022. Export stagnated year on year, with imports growing by 3.7%, which resulted in a negative contribution of foreign trade to GDP dynamics of 2 p.p.

Problems with the export of goods are documented by the results of the manufacturing industry, whose gross added value in Q1 was down by 0.7%, with services clearly taking over the role as the economy's driving force. The volume of gross added value grew across all service sectors, with gross added value in trade, transport, hospitality and accommodation growing most dramatically. The rise of 14.1% was linked with sustained strong household consumption. Growth in real household spending will gradually start to be restricted by high inflation.

The year-on-year growth in consumer prices in Q1 reached 11.2%, while inflation in April accelerated to 14.2%. Core inflation in the Czech Republic, measured by Eurostat's methodology in April, stood at 11.2%, being the highest in all of the EU. Cost inflationary pressure related to the war in Ukraine fell on extremely fertile ground in the Czech Republic, nourished by pressures from the labour market and very loose fiscal policy. The unemployment rate in April fell to 3.3% and the number of job seekers (244,000 persons) was 100,000 lower than the number of vacancies.

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

The development of the economy as well as additional costs linked to the refugee crisis have affected public budgets. The most important of these, the state budget, closed May with a deficit of CZK 189.3 bn (net of EU-related revenues and expenditures, the deficit was CZK 1.1 bn higher), which represents nearly 68% of the approved deficit. Whereas the volume of expenditures paid out (expressed as a percentage of budgeted expenditures) is slightly lower than in previous years, state budget revenues are beginning to lag behind those of previous years.

Thus far, the development of revenues does not indicate that the higher inflation would bring in significant additional revenue compared to the approved budget. On the other hand, additional expenditure linked to the resolution of the refugee and energy crises can be expected to gradually manifest, which will drive a higher deficit. It is therefore evident that an amendment of the State Budget Act will be required to ensure that it is realistic.

In the two previous months, the government discussed several documents in which it revealed its fiscal policy plans. Whereas the Convergence Programme introduced in April 2022 had assumed public finance deficits to fall below 3% of GDP in 2024, the document "Preparation of the state budget of the Czech Republic for 2023 and a medium-term outlook for 2024 and 2025" discussed on 1 June 2022 already works with such state budget deficit assumptions, that reaching that threshold is unlikely. In the document, the government assumes that the state budget deficit between 2023 and 2025 will stagnate just below CZK 300 bn, which – even if the current surplus finance of the local public institutions sub-sector (around 0.5% GDP) is maintained, and with balanced finances of health insurance funds – will mean year-on-year fiscal consolidation of only 0.2% GDP per year. This is absolutely insufficient, given the depth of current deficits. Furthermore, it cannot be ruled out that investment projects implemented by municipalities and regions will become more expensive due to the rising prices in the construction sector and other inflationary pressures, resulting in a decline of their surpluses.

The proposed trajectory of the state budget deficit unfortunately points to a significant structural imbalance that is not being successfully adequately reduced. The extent of the structural deficit of public budgets that is not influenced by the position in the economic cycle currently ranges around 3% GDP, which represents around CZK 220 bn. This reflects the fact that the revenue side of public budgets does not suffice to cover public expenditure.

The CFC has described the reasons that have led to the imbalance several times in the past: these are the consequences of steps taken in previous years, often with a reference to the COVID-19 pandemic, even though they were substantially unrelated. On the revenue side, this means, above all, the significant reduction in individual income taxation (approximately CZK 120 bn.), the abolition of the tax on the acquisition of real estate (approximately CZK 13-14 bn.), as well as other partial adjustments of the excise tax on diesel (approximately CZK 6 bn). On the expenditure side, this includes, above all, higher-than-statutorily-mandated indexation of pension insurance benefits and the increases of certain other social benefits. All this in combination with salary increases for a significant part of government sector employees (especially teachers) resulted in a significantly expansive fiscal policy in 2020 and 2021. In particular, last year's massive fiscal stimulus[1] was macroeconomically inappropriate, because – given the situation on the labour market – it did not make a significant contribution to economic recovery. Conversely, it very negatively reinforced inflationary pressures in the economy that emerged as a result of the increased willingness to spend after the relaxation of the restrictions on the supply side and a significant increase in the prices of energy commodities.

The CFC believes that, despite the difficult situation caused by the attack on Ukraine by the Russian Federation, it is not possible to abandon the effort to return public budgets to a sustainable level. It is evident that if the government does not want to limit expenditures on pensions, healthcare, and

[1] Fiscal effort reached -1.5% of GDP.

education (which constitute the main expenditure blocks in public budgets) and, furthermore, it intends to increase defence spending, which will not be possible without strengthening public budget revenues. A reduction in certain government agendas and a reduction in the number of government sector employees could ease deficit pressures; however, the potential savings can be expected to be in the order of only single billions of crowns. In this context, it must be noted that, given the situation on the country's job market and the continued decline in the unemployment rate (the lowest in the EU on a sustained basis), there is probably no other European country with such great room for the downsizing of its public sector without an adverse impact on the employment rate. At the same time, however, it must be noted that the above-mentioned document "Preparation of the state budget of the Czech Republic for 2023 and a medium-term outlook for 2024 and 2025" does not foresee a reduction in the number of positions paid from the state budget.

Furthermore, the CFC believes that greater effort is required to bring public budgets to a sustainable level, in order to create room for a potential fiscal policy response to a further crisis in the future. Unfortunately, the argumentation about the atypicality and exceptionality of the COVID-19 crisis has led to a nearly general acceptance of extremely high public finance deficits. But that crisis was soon replaced by a new crisis. The CFC is convinced that, as a precautionary measure, public budgets must be kept manageable even at this time.

Furthermore, it must be noted that with every year in which steps leading to a remedy of the situation are postponed, we are approaching the beginning of the 2030s, when the effects of the ageing of the population will start to be felt. The CFC warns against downplaying the situation and against simplifications claiming that the problem would be solved by migration from Ukraine. Even if a significant number of the refugees stayed here, the CFC's calculations show that the positive impact on the long-term sustainability of public finance will be only limited.

The high level of inflation brings with it significant negative impacts on society, which are skewed against the lower- and middle-income groups. Hence, it is evident that the phenomenon requires government intervention. The CFC believes that those interventions should be relatively frugal, as their potential across-the-board scope and large, fiscal scope could contribute to a more permanent nature of inflation. Furthermore, the CFC maintains that maximum use should be made of the existing system of social benefits which can be adjusted parametrically. This is, however, conditioned on its administrative simplification. If further measures are taken, such as the proposed child allowance of CZK 5,000 or reductions in certain taxes (road tax, tax on mineral fuels), these should be one-off and limited in duration. It is necessary to avoid as far as possible making those measures permanent, as it would further deepen the above-mentioned structural imbalances and delay the return of public finance to a sustainable level.