

# 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 has regularly, on a quarterly basis, informed the public about its conclusions.

#### **Macroeconomic background**

The economy did continue to recover in Q3; nevertheless, closer inspection reveals mixed signals. The revised estimate of year-on-year GDP growth was 3.1%. The economy was driven mainly by household consumption, with a strong year-on-year rise of 6.4 %, nearly double the current expectation of the Ministry of Finance. Investment demand has been reviving slowly, its growth of 0.7 % being well below expectations. Exports fell by 2.3 % year on year, while imports went up by 8.3%. This is linked to the extremely high rise in inventories, and the question is how quickly and to what extent these inventories will be embodied into exports or investments.

In terms of the development of gross value added in individual sectors, the unfavourable performance of industry dominated. High year-on-year growth of GVA observed in the second quarter, was followed by stagnation in the third quarter. Industrial performance was strongly influenced by the decline in the output of the automotive industry – by more than 20% year-on-year and by more than 10% quarter-on-quarter.

For the time being, a quarter of entrepreneurs in industry expect demand to improve in the next six months, and only 10% of industrialists are concerned about a further decline in exports. Industrial enterprises are not planning significant lay-offs – they are expected only by a sustained 10 % of entrepreneurs. However, the situation is worse in the service sector, as more than one quarter of the entrepreneurs responding to the survey plan to reduce the staff.

Expectations of entrepreneurs in industry, the service sector, and trade, in terms of their own price increases, are beginning to change with unusual vigour. Not only 42% of industrialists and a quarter of service providers, but also half of entrepreneurs in trade plan to raise prices, which are record high figures, since the surveys were first published back in 1993.

Inflationary pressures have been gaining momentum in recent months. In October, the year-on-year growth of consumer prices reached 5.8%. According to the CNB, inflation should culminate at the beginning of next year, after which price growth should stabilise. As for households, the historically

high inflation expectations are reflected in their fears of a deterioration of their own financial situation, and there are growing concerns about joblessness, which could ultimately weaken the currently robust consumer demand.

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

Public budgets are currently being affected both by the pandemic situation, which has been worsening continuously since September, and by the expansionary fiscal policy set-up.<sup>1</sup> Both are dominantly reflected in the state budget balance, as it bears the brunt of the one-off measures and is also the most affected by the sharp reduction in personal income tax, which has been effective since January of this year.

During November, the state budget deficit deepened yet further, reaching CZK 401.5 billion, as at 30 November. Net of transactions from the EU, the deficit is CZK 11.6 billion more favourable (CZK 389.9 billion). The November slump was mainly due to an increase in transfers to other parts of the public budget system (local and regional authorities, extrabudgetary funds).

Given that neither a decrease in expenditure pressures on the state budget nor a significant acceleration of revenues can be expected in December, its balance is highly likely to exceed CZK 400 billion. Fortunately, the originally planned deficit of CZK 500 billion, which was only a very rough estimate, will not materialise. In terms of other components of the public budget system, the CFC expects local government budgets to show a slight surplus; however, that will be offset by a deficit in the public health insurance system of a roughly similar size.

The outlook for fiscal policy is currently undergoing a significant transformation, as a cabinet is being formed following the October election to the House of Deputies. This newly forming cabinet places greater emphasis on a faster pace of public finance consolidation. The CFC welcomes this, but until a concrete consolidation strategy and the individual steps to improve public finances are presented, the reality of this intention cannot be assessed. Faster consolidation of public budgets may benefit slightly from a higher-than-expected rate of growth in wages and salaries in the economy, which would generate additional revenues from additional statutory insurance and personal income tax revenues.<sup>2</sup> On the other hand, the worsening of the COVID-19 epidemic will have the negative effect of slowing the economic recovery and has already forced the reactivation of certain support programmes. Another risk is posed by the sharp increase in energy prices, which will likely require additional public spending to stabilise the financial situation of affected households.

Accelerating inflation will affect both the expenditure and revenue sides of public budgets. Unless households start to reduce real consumption despite higher prices, VAT will generate higher revenues; however, this positive development (for public budgets) will be counteracted by an autonomous increase in pension benefits, where the inflation rate enters into the indexation formula. At the same time, high dynamism of price growth may slow the expected rate of growth of the debt quota, should the yield rates of newly issued government bonds not respond significantly to

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<sup>1</sup> According to a forecast of the Ministry of Finance of the Czech Republic, the year-on-year deterioration of the structural balance between 2020 and 2021 will be around 2.8% GDP. MF CR (2021): Macroeconomic Forecast for the Czech Republic, November 2021, p. 12.

<sup>2</sup> In November, the Ministry of Finance increased the expected public budget revenues for 2022 for personal income tax by CZK 7 billion and both statutory insurance premiums by CZK 30 billion compared to the August estimate. <https://www.mfcr.cz/cs/verejny-sektor/makroekonomika/vybor-pro-rozpocetove-prognozy/jednani-vyboru-pro-rozpocetove-prognozy>

this growth. Here, however, the CFC points out that this way of “solving” the debt problem cannot be considered appropriate, as it is a consequence of a drop in the value of money.

Furthermore, the CFC warns that, despite the possible positive effects of higher tax revenues in the future, the main problem of Czech public finances remains the high structural imbalance. The structural deficit for this year will be around 5.3% of GDP, which corresponds to CZK 320 billion. It should be stressed that this type of deficit will not be significantly reduced by economic growth, and that discretionary measures will need to be adopted in order to eliminate it, i.e., changes in the level of public revenue and expenditure. Given the extent of the imbalance, the CFC continues to believe that its reduction will not be possible by a mere adjustment on the expenditure side, but that it will also require an increase in government revenue.

In connection with the efforts to accelerate the consolidation of public finances, representatives of the new government coalition declare that the currently proposed budget, with a planned deficit of CZK 376.6 billion, is unacceptable and that it will have to be revised. The aim should be to reduce the proposed deficit, primarily by reduction of public spending. The CFC welcomes this effort. At the same time, however, it should be noted that the recasting of the draft budget will imply working with a provisional budget. The CFC contends that, if the period for which the instrument is used is short, of two (or a maximum of three) months, the positives of faster consolidation will outweigh the negatives. The greatest negatives are the complications in the management of individual chapters, as well as the uncertainty with respect to the extent of subsidy relations with other public budgets (especially those of local and regional authorities and the State Fund for Transport Infrastructure), and last but not least, the limited possibility of launching new large investments. The use of a provisional budget must be communicated transparently, in order to avoid it being interpreted by foreign investors as a result of political instability, for example.

Furthermore, the CFC notes, in line with its mandate, that the actions of the future government in the area of public finances should not concentrate solely on eliminating medium-term imbalances, but that attention should also be paid to long-term imbalances. These are linked to the ageing population effect, which will start to affect Czech public finances at the beginning of the 2030s. It is therefore necessary to start preparing such adjustments to the main areas of expenditure, in particular the pension insurance system, in order to ensure their financial sustainability in the future.