The Czech Fiscal Council

REPORT ON COMPLIANCE WITH THE RULES OF BUDGETARY RESPONSIBILITY FOR 2021

September 2022
Czech Fiscal Council

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Introduction

The Czech economy, like most economies around the world, was still being affected by the COVID-19 pandemic in 2021. Government budgets again ended in a large deficit, even though the economy returned to a growth path. This was due mainly to the adoption of a range of structural revenue and expenditure measures, some of which had nothing to do with the COVID-19 crisis. The approach taken to the fiscal rules also turned out to be very negative. Act No. 23/2017 Coll., on the Rules of Budgetary Responsibility, as amended (the "Act"), was amended twice during 2020, in the second case through a private member's motion to amend, which unfortunately had an adverse effect on the applicability of the current version. The amendment consisted primarily in deactivating the structural balance rule for 2021 and relaxing it very significantly for 2022. The result is the present state of Czech public finance, which is on a collision course with the debt brake by the end of this decade.[1] It's a classic example of what happens when the fiscal rules are adapted to fiscal policy and not vice versa.

The major changes made to the Act in 2020 point to a general lack of understanding of the logic of the fiscal rules. If they are to be of any use, the rules need to be stable over the long term. They cannot be altered whenever compliance with them requires the introduction of unpopular measures. The Czech Republic still has an advantage over the majority of EU countries in the form of relatively low government debt. However, the relaxation of the fiscal rules and the ensuing over-optimistic deficit outlook for the years ahead makes it highly likely that we will forfeit this advantage in the foreseeable future.

This Report on Compliance with the Rules of Budgetary Responsibility (the "Report") contains an assessment of compliance with the fiscal rules in 2021. Preparing the Report is one of the main duties of the Czech Fiscal Council (CFC) set out in the Act. Although the Report evaluates the information relating to 2021 only, it also examines the period before that year. Unlike previous years' Reports, this one does not look at expected trends in future years. This is because at the time the Report was prepared (early September 2022) the main parameters of the state budget for 2023 had not yet been approved and the preparation of the budget for that year and the outlook for 2024 and 2025 was moreover subject to additional uncertainty associated with resolving the acute energy crisis and mitigating its impact on the real economy.

[1] CFC (2022): Report on the Long-Term Sustainability of Public Finances (see https://unrr.cz/en/report-on-the-long-term-sustainability-of-public-finances/).

1 General government finances

The Czech economy recorded real GDP growth of 3.3% in 2021, although GDP at constant prices (CZK 5,190 billion) was still below the 2019 pre-Covid level (CZK 5,304 billion).[2] The main contributors to the GDP growth in 2021 were change in inventories (4.8 pp) and household expenditure (1.8 pp), while resurgent international goods trade had the opposite effect (–3.6 pp). The economy fluctuated around its potential output level. According to the Czech Statistical Office[3] (CZSO), the general government deficit reached CZK 359.4 billion, or 5.9% of GDP, the biggest deficit since 2003. Net of one-off and temporary measures, the structural deficit can be estimated at 4.3% of GDP.[4] The debt-to-GDP ratio rose by 4.4 pp to 42% in 2021.

This year, the economy and public finances will be affected primarily by the ongoing war in Ukraine and the high rate of inflation. According to the August forecast of the Czech Ministry of Finance[5] (MF CR), real GDP will record growth of 2.2% and the general government deficit will fluctuate around 3.8% of GDP in 2022. The ratio of government debt to GDP is expected to rise to 42.4% of GDP. This is 0.4 pp higher than the 2021 figure. That the year-on-year increase in the ratio is so modest is due mainly to substantial nominal GDP growth of 11.3%, reflecting a large rise in the price level. However, the aforementioned estimates are subject to considerable uncertainty relating primarily to the form and extent of the expected government intervention in energy prices.

The Ministry of Finance forecasts a reduction in economic growth to 1.1% in 2023 and an acceleration to 3% in 2024. According to the Draft Medium-term Outlook for 2024 and 2025, general government will record a structural deficit of around 3% of GDP.

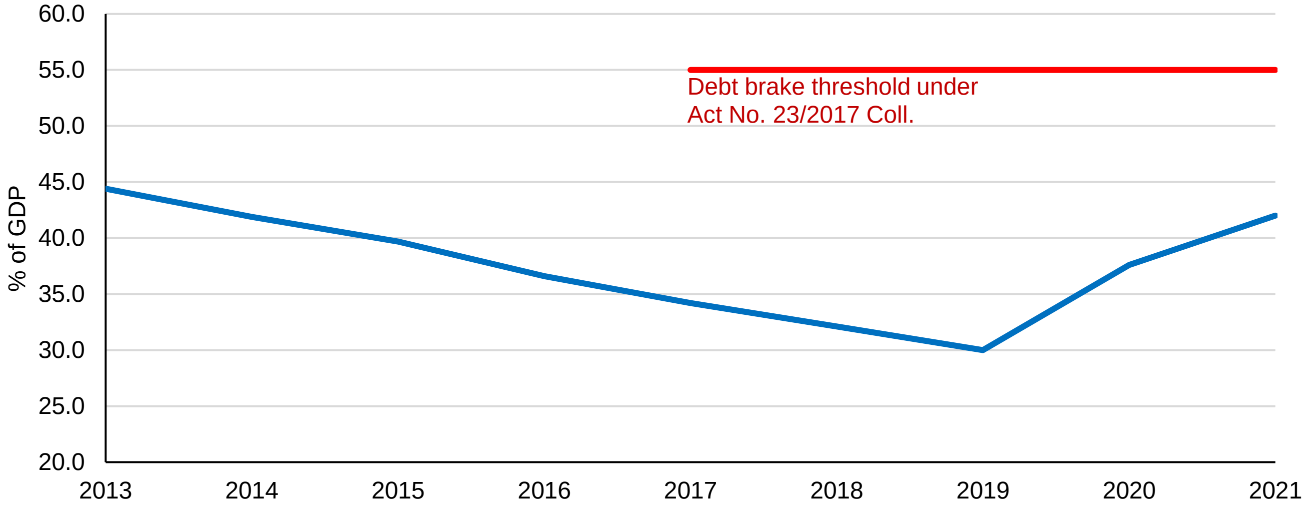
2 The debt rule

The debt rule is defined in Sections 13–16 of the Act. Specifically, under Section 13 of the Act, the ratio of general government debt minus the state debt financing reserve to GDP is monitored. If this ratio exceeds 55% of GDP (the “debt brake threshold”), the measures set out in Section 14 of the Act are applied. These measures would lead to a reduction in the active use of fiscal policy for macroeconomic stabilisation and would restrict the activity of many general government organisations. A breach of the debt brake threshold would also send negative signals to the financial markets. This could be reflected in an increase in the risk premium, which would contribute to growth in the debt. Section 16 of the Act provides that if the ratio of debt to GDP increases above 60% of GDP, the government will propose measures leading to a decrease of this level.[6]

In its communication of 14 April 2022 based on CZSO and MF CR data, the CFC announced the value of the debt rule indicator as of 31 December 2021 at 41.93% of GDP. Owing to a revision of the national accounts, the nominal GDP figure for 2021 was later reduced, so the ratio of general government debt minus the state debt financing reserve increased to 42.02% of GDP (see Chart 1). Despite the increase in the ratio, the reference values defined in the Act and stated above were not exceeded.

[2] MF CR (August 2022): Macroeconomic Forecast of the Czech Republic.
[3] CZSO (2022): Notification of Government Deficit and Debt – 2021 (First Notification, Data Notified by Eurostat), published on 22 April 2022. See https://www.czso.cz/csu/czso/ari/notification-of-government-deficit-and-debt-2021-first-notification-data-notified-by-eurostat.
[4] In its August macroeconomic forecast, the Ministry of Finance gave notification of a probable retrospective revision of this figure for 2021 of 0.7% of GDP due to higher tax revenue. Should this be confirmed by the CZSO, the overall general government deficit would be 5.2% of GDP and the structural deficit 3.6% of GDP in 2021.
[5] MF CR (August 2022): Macroeconomic Forecast of the Czech Republic.
[6] The exact specifics of these measures are contained in Article 2(1a) of Council Regulation (EC) No 1467/97. Above all, the measures define a minimum rate of decrease of the debt-to-GDP ratio to the reference value of 60% when the ratio exceeds the reference value.

Chart 1 General government debt minus the state debt financing reserve



Source: MF CR (August 2022): Macroeconomic Forecast of the Czech Republic; CFC calculations.

Conclusion: The CFC states that the reference values of the general government debt indicator defined in Section 14 and Section 16 of the Act were not exceeded in 2021.

3 The rule for determining total general government expenditure and deriving the state budget and state funds expenditure framework

The state budget for 2021 and the budgets of other relevant general government entities were prepared during 2020. In April 2020, the Ministry of Finance[7] set total general government expenditure for 2021 at CZK 2,716 billion and the state budget and state funds expenditure framework (including the EU) for 2021 at CZK 1,792 billion (see Table 1).

During the preparation of the state budget, the state budget and state funds expenditure framework was revised to CZK 1,848 billion in October 2020 in accordance with Section 8 of Act No. 218/2000 Coll., on Budgetary Rules and pursuant to Section 1 of Act No. 288/2020 Coll.[8] The changes to the expenditure framework were made possible primarily by higher estimated revenue from EU funds and financial mechanisms (CZK 58.6 billion including the allocation from the Recovery and Resilience Facility). By contrast, the framework had to be reduced by CZK 54.7 billion owing to the updated forecast for state budget and state funds revenue, which was predicting lower tax revenue and social insurance contributions. Pursuant to Section 1 of Act No. 288/2020 Coll., it was still possible to modify the expenditure frameworks for 2021–2023 by taking into account the changes stemming from the different macroeconomic forecast. The different evolution of wages and salaries caused a deterioration in the forecasts for social insurance (CZK 25.5 billion) and health insurance (CZK 11.8 billion). Both these amounts were used to further increase the expenditure framework for 2021.

The total approved level of state budget and state funds expenditure was CZK 1,849 billion. The procedure for determining total general government expenditure and deriving the state budget and state funds expenditure framework was followed in the process of approval of the state budget and state funds expenditure level.

Act No. 600/2020 Coll., on the State Budget of the Czech Republic for 2021, of 18 December 2020 set state budget expenditure at CZK 1,808 billion. On 22 December 2020, the Chamber of Deputies passed a “tax

[7] MF CR (2020): General Government Budgetary Strategy of the Czech Republic for 2021–2023 (the “Strategy”; in Czech). The Strategy was based on the first amendment of the Act (see Act No. 207/2020 Coll. of 22 April 2020), the declared aim of which was to create fiscal space for 2021 – the cap on the structural deficit (the basis for the expenditure fiscal rule) was raised from 1% to 4% of GDP. In subsequent years, public finances were to be consolidated at a rate of 0.5% of GDP per year by reducing the structural deficit.
[8] MF CR (2020): Documentation on the Draft Act on the State Budget of the Czech Republic for 2021: B – Report on the Draft Act of the State Budget of the Czech Republic for 2021 (in Czech).

package"[9] generating significant changes on the revenue side of the state budget. Fundamental changes included the abolition of "supergross wage" taxation and the introduction of a progressive rate with two marginal rates – 15% and 23%. In addition, the basic taxpayer discount was increased and minor changes were made to excise duties. The approval of these changes gave rise to a need to amend the state budget for 2021. So, on 18 February 2021, the Chamber of Deputies passed Act No. 92/2021 Coll., amending Act No. 600/2020 Coll., on the State Budget of the Czech Republic for 2021. The new budget set expenditure at CZK 1,886 billion.

Claims arising from unconsumed expenditure amounted to CZK 174.7 billion at the start of 2021. CZK 149.4 billion in claims arising from unconsumed expenditure was employed in budgets or terminated in 2021. CZK 106.4 billion was actually drawn down.

Actual general government expenditure totalled CZK 2,839 billion and actual state budget and state funds expenditure CZK 1,951 billion in 2021. This is CZK 103 billion more than the figure in the revised framework.

Table 1 Key expenditure rule indicators and the figures actually recorded in 2021 (CZK billions unless stated otherwise)

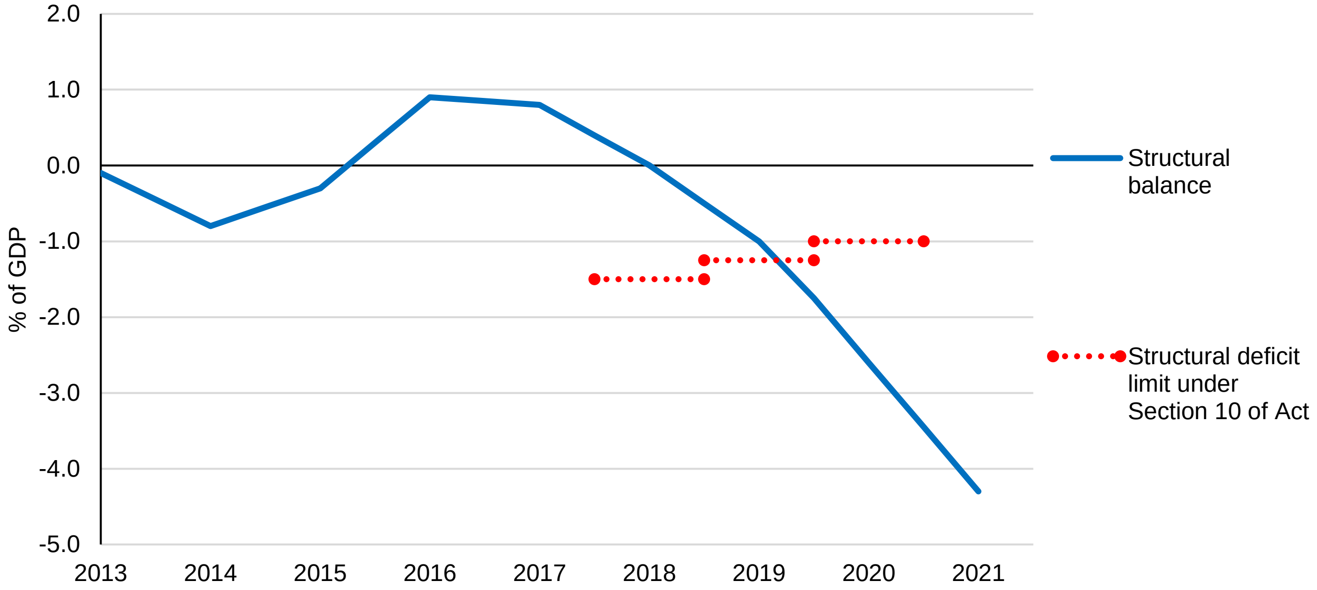
	Budgetary strategy (April 2020)	Draft state budget (October 2020)	Approved state budget (December 2020)	Actual figure (August 2022)
General government expenditure	2,716			2,839
SB and SFs expenditure framework, inluding EU	1,792	1,848		
SB			1,808	1,907
SFs			178	183
Transfers from SB to SFs			137	139
SB and SFs, total			1,849	1,951
GDP at current prices	5,781	5,860		6,108
Structural balance (% of GDP)		-4.5		-4.3
Output gap (% of potential output)		-1.2		0.1

Source: MF CR (2020): General Government Budgetary Strategy of the Czech Republic for 2021–2023; MF CR (2020): Documentation on the Draft Act on the State Budget of the Czech Republic for 2021; MF CR (2022): State Treasury Monitor; MF CR (2022): Treasury Performance for January–December 2021; MF CR (August 2022): Macroeconomic Forecast of the Czech Republic; CZSO (2022): National Accounts Database; CFC calculations.
Note: SB = state budget, SFs = state funds. The totals in the table may be subject to inaccuracies due to rounding.

The reason for setting the state budget and state funds expenditure framework under the Act is to prevent the defined cap on the structural deficit from being exceeded. When assessing compliance with this rule, we therefore need to monitor not only the procedure used to derive the expenditure framework itself, but also whether the cap on the general government structural deficit was exceeded. However, the state budget and state funds expenditure framework was progressively relaxed during 2020. This process culminated with the adoption of the second amendment of the Act, which sets no specific figure for the structural deficit at all for 2021 (see the absence of a cap for 2021 in Chart 2; the caps for 2018–2020 are indicated with red dotted lines). As a result, it is not possible to compare the actual structural balance with the cap and thus assess compliance with the underlying objective of the rule.

[9] Act No. 609/2020 Coll., amending some laws in the tax area and some other laws. Among other things, this law led to a second amendment of the Act enabling the fiscal rule discussed in this section to be relaxed even further. This amendment set no maximum permissible structural deficit for 2021 at all. It therefore completely disabled one of the budget responsibility safeguards. The level of this indicator for 2022 was derived from the forecast for its value given in September 2021 at the latest. The future reduction of the structural deficit at a rate of 0.5% of GDP a year remained in force. However, the original version of the Act before the two amendments contained, for example, one-off measures that could have been applied at the time of the pandemic instead of ad hoc changes to the Act. As a result, the extraordinary fiscal support measures would not have been mixed with measures that will affect the structure of public finances for a long time to come. We examined the amendments of the Act in more detail in the previous edition of the Report; see CFC (2021): Report on Compliance with the Rules of Budgetary Responsibility for 2020 (https://unrr.cz/wp-content/uploads/2021/11/Report-on-Compliance-with-the-Rules-2020.pdf).

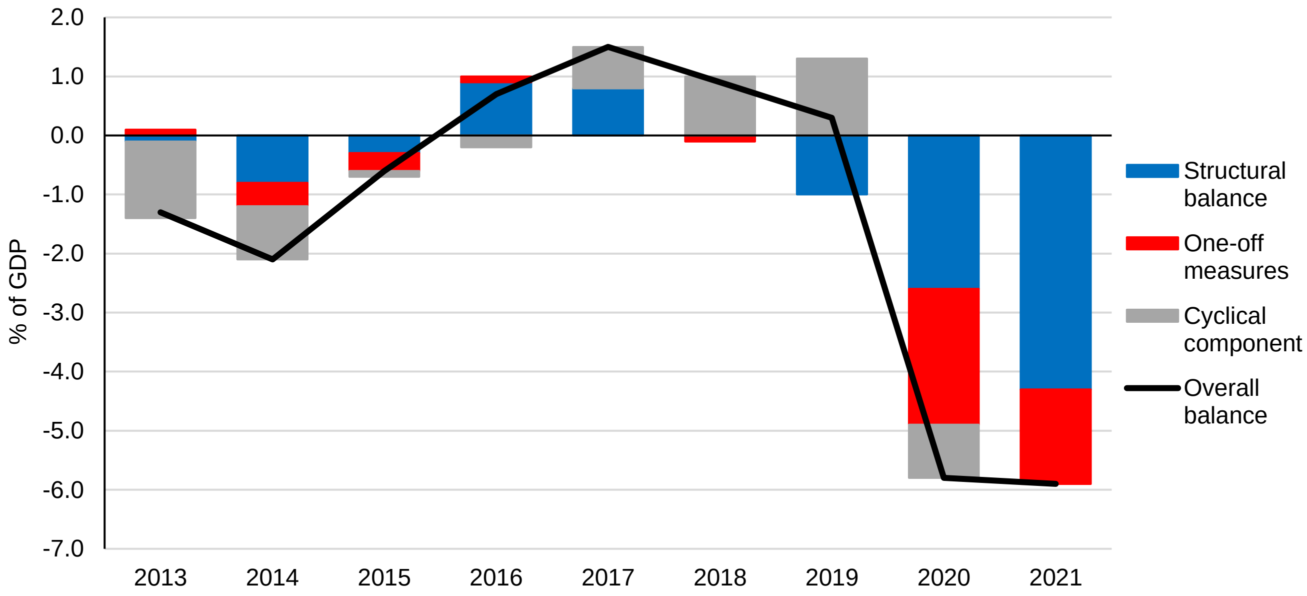
Chart 2 The general government structural balance



Source: CZSO (2022); MF CR (August 2022): Macroeconomic Forecast of the Czech Republic; CFC calculations.

Chart 3 provides the breakdown of the overall general government balance. It shows that the dominant part of the deficits recorded since 2021 is due not to the one-off and temporary measures taken in connection with the COVID-19 pandemic, but to a permanent change in the level of taxes and expenditure that cannot be explained by the pandemic. The surpluses recorded in 2018 and 2019 were evidently due mainly to the cyclical component of the balance caused by positive economic developments. The structural balance, by contrast, has shown a downward trend since 2017.

Chart 3 Decomposition of the overall general government balance



Source: CZSO (2022); MF CR (August 2022): Macroeconomic Forecast of the Czech Republic; CFC calculations.

Conclusion: The CFC states that the procedure for determining total general government expenditure and deriving the state budget and state funds expenditure framework was followed in the process of approval of the state budget and state funds expenditure level for 2021. However, the assessment of compliance with the rule is rendered impossible by the second amendment of the Act, which did not set a specific figure for the structural balance for 2021 and also abolished the application of the corrective part.

4 Local and regional government finances

The Constitution of the Czech Republic defines municipalities and regions as local and regional authorities.[10] Section 17 of the Act defines a special budgetary responsibility rule for the finances of municipalities and regions. That rule involves monitoring a debt criterion and, where it is exceeded, monitoring the rate of decrease of the debt. Local and regional authorities also establish many other organisations (mostly in the form of entities partially subsidised from public budgets), the finances of which affect the overall results of the general government sector. This section first presents the overall financial results of the local government subsector and then evaluates the frequency and seriousness of violations of the fiscal rule.

4.1 Local government finances 2018–2021

The local government subsector[11] has reported budget surpluses in the last four years and has thus contributed to better financial results of the overall general government sector each year. In 2021, the total revenue of the subsector was CZK 817.9 billion, up almost CZK 50 billion on the previous year. Local government revenue accounted for 33% of total general government revenue and local government expenditure for 27.6% of total general government expenditure. The local government surplus increased by CZK 8.3 billion year on year to CZK 34.6 billion in 2021, amounting to 0.6% of GDP. Table 2 contains the relevant figures.

Table 2 Local government finances in the Czech Republic 2018–2021

	2018		2019		2020		2021	
	CZK bn	% of GDP	CZK bn	% of GDP	CZK bn	% of GDP	CZK bn	% of GDP
Revenue	659.1	12.2	717.6	12.4	768.0	13.5	817.9	13.4
Expenditure	635.5	11.7	680.0	11.7	741.7	13.0	783.3	12.8
Balance	23.6	0.4	37.6	0.6	26.3	0.5	34.6	0.6

Source: CZSO (2022); CFC calculations.
Note: The totals in the table may be subject to inaccuracies due to rounding.

The surpluses of local and regional authorities were due mainly to higher tax revenue arising from a change to the budgetary assignation of taxes valid since 1 January 2021, which increased their share of national gross VAT and personal and corporate income tax revenue.[12]

As is evident from Table 3, the downward trend in the share of local government in total general government debt also corresponds to the local government surplus. However, nominal local government debt increased slightly in 2021 compared to previous years, reaching CZK 87 billion (approximately 1.4% of GDP). This represented just 3.4% of total general government debt.

Table 3 Local government debt in the Czech Republic 2018–2021

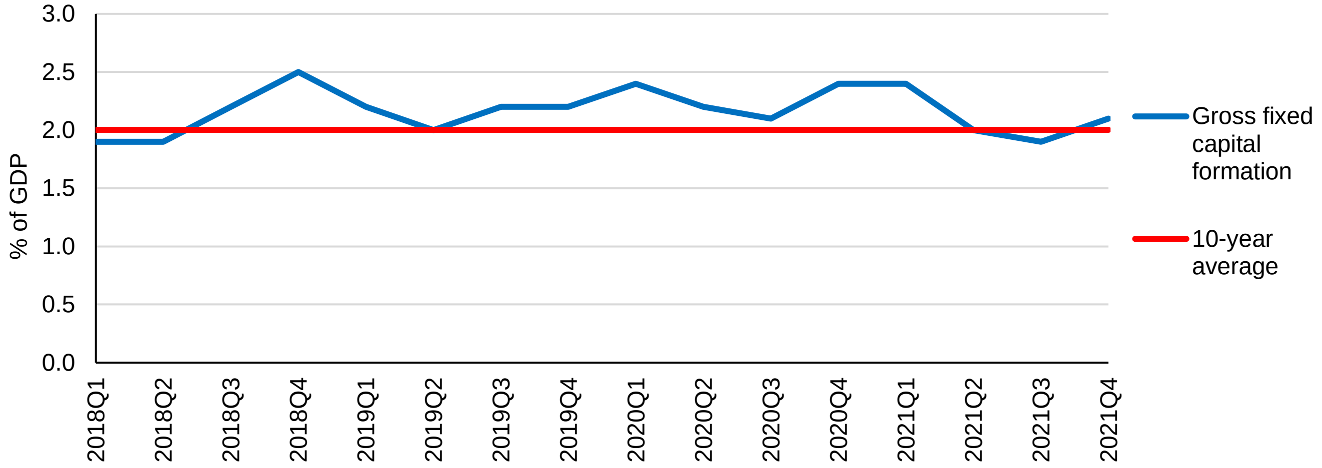
	2018	2019	2020	2021
Debt (CZK billions)	84.0	84.4	86.7	87.0
Ratio to GDP (%)	1.6	1.5	1.5	1.4
% of total general government debt	4.8	4.9	4.0	3.4

Source: CZSO (2022); CFC calculations.

Local government recorded a slight decline in investment activity in 2021. The level of investment was approximately CZK 127.7 billion, which is CZK 26.6 billion above the ten-year average for 2012–2021 (see Chart 4).[13]

[10] Some other publications use the alternative term “territorial self-governing units” (a more literal translation of *územní samosprávné celky* as used in the Czech legislation). See, for example, Ministry of Finance (2022): “Statement of sources and uses of cash of territorial self-governing units”. In this Report, we use “local and regional authorities”.
[11] Under the ESA 2010 methodology, the local government subsector is a part of the general government sector. It consists of local government units and organisations directly accountable to them, i.e. all organisations having a local sphere of competence and financed out of local budgets.
[12] See the amendments of Act No. 540/2020 Coll. and Act No. 609/2020 Coll.
[13] Gross fixed capital formation in the local government subsector gradually increased from 1.3% of GDP in 2016 to 2.1% of GDP in 2021.

Chart 4 Local government investment in the Czech Republic 2018–2021



Source: Eurostat (2022); CFC calculations.

Conclusion: The finances of local and regional authorities (and organisations accountable to them) do not pose significant risks to the overall financial results of the general government sector. On the contrary, they have been contributing to stabilising general government finances for quite some time now. The debt of local and regional authorities is also very low and, as a whole, thus does not represent a significant risk factor in terms of growth in general government debt. The investment activity of local and regional authorities declined slightly in 2021 to approximately 2% of GDP.

4.2 The budgetary responsibility rule for local and regional authorities and compliance therewith in 2021

Section 17 of the Act sets the following rule for local and regional authorities:

a) A local or regional authority shall manage its finances in the interests of maintaining sound and sustainable public finances such that its debt[14] at the balance-sheet date does not exceed 60% of its average annual revenues[15] over the last four budget years (hereinafter the “debt criterion”).
b) Should the debt of a local or regional authority at the balance-sheet date exceed 60% of its average annual revenues over the last four budget years, the local or regional authority shall reduce it in the following calendar year by at least 5% of the difference between the amount of its debt and 60% of its average revenues over the last four budget years (hereinafter the “debt reduction rule”).

The Ministry of Finance monitors the finances of local and regional authorities on the basis of financial data and accounting records submitted by municipalities. In 2021, this monitoring covered 6,264 local and regional authorities of the Czech Republic, i.e. 6,251 municipalities,[16] including the City of Prague, and 13 regions.

Ten of the total of 575 municipalities whose debt as at 31 December 2020 was higher than 60% of their average revenues over the previous four years were not compliant with the debt reduction rule. Non-compliance with the obligation during 2021 was due to deferred loan repayment. In 2022, these municipalities have been servicing their loans in accordance with repayment schedules, so no municipality will have its share in tax revenue suspended.

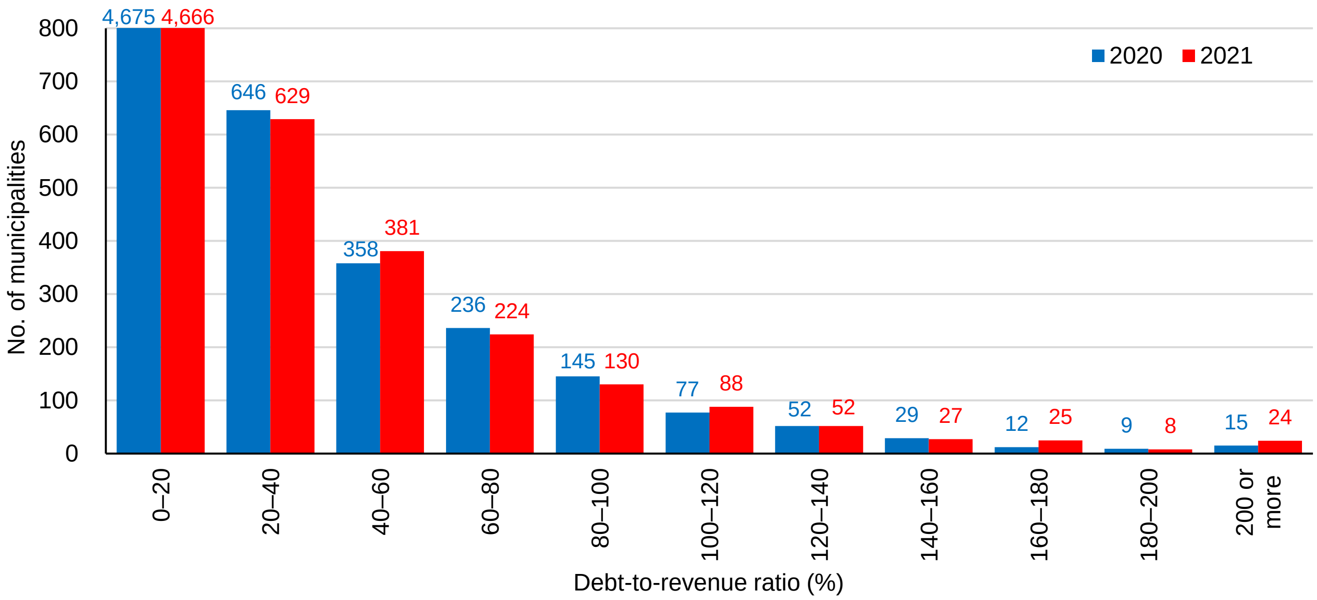
Indebtedness in relation to the debt indicator

The budgetary responsibility rule indicator (i.e. the percentage ratio of debt to average revenue over the last four years) was above 60% as of 31 December 2021 for 578 of the total of 6,254 municipalities (i.e. for 9.2% of all

[14] For the purposes of the Act, the debt of a local or regional authority means the value of outstanding liabilities arising from bonds issued, credit, loans and returnable financial assistance received, guarantees honoured and bills of exchange issued.
[15] For the purposes of the Act, the revenues of a local or regional authority mean the sum of all monies received into its budget during the budget year, consolidated in accordance with another legal regulation.
[16] The municipalities of Bohuslavice, Vlachovice and Fryšták are excluded from monitoring due to failure to submit financial statements to the Central State Accounting Information System.

municipalities). A total of 427,170 people, i.e. approximately 4% of the Czech population, live in these municipalities (in 2020, approximately 5.1% of the population were living in municipalities exceeding the indicator).[17] Figures are also available in Chart 5.

Chart 5 Numbers of municipalities in ranges according to the percentage level of the budgetary responsibility rule indicator, 2020 versus 2021



Source: MF CR (2021): Information on the Monitoring of Local and Regional Authorities' Finances for 2020; MF CR (2022) Information on the Monitoring of Local and Regional Authorities' Finances for 2021; CFC calculations.

The total debt of municipalities in 2021 was CZK 63.8 billion, i.e. CZK 1.5 billion less than in 2020. The average debt of municipalities was 17.6% of the four-year annual revenue average (16.4% in 2020). A total of 3,555 municipalities, i.e. 57% of the total, were entirely free of debt, the same as in 2020.[18] However, the number of municipalities whose budgetary responsibility rule indicator exceeded 200% increased from 15 to 24.

Table 4 Number of municipalities exceeding the 60% debt criterion of the budget responsibility rule

No. of inhabitants of municipality	No. of municipalities		No. of municipalities exceeding 60% debt criterion value		% of municipalities exceeding 60% debt criterion value (%)	
	2020	2021	2020	2021	2020	2021
0–100	438	425	18	17	4.1	4.0
101–200	976	982	81	71	8.3	7.2
201–500	1,998	1,984	206	221	10.3	11.1
501–1,000	1,360	1,370	153	166	11.3	12.1
1,001–2,000	776	781	80	70	10.3	9.0
2,001 or more	706	712	37	33	5.2	4.6
Total	6,254	6,254	575	578	9.2	9.2

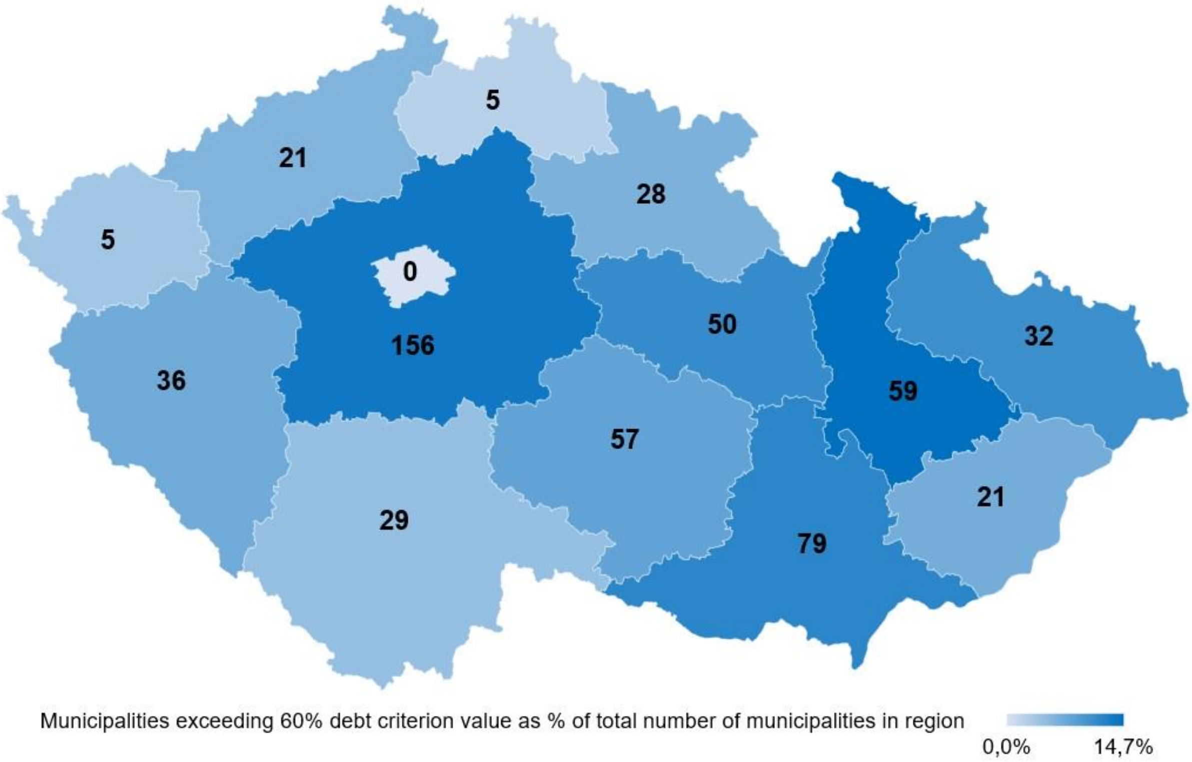
Source: MF CR (2021): Information on the Monitoring of Local and Regional Authorities' Finances for 2020; MF CR (2022) Information on the Monitoring of Local and Regional Authorities' Finances for 2021; CFC calculations.

Table 4 shows that in 2021, municipalities with 201–500 and 501–1,000 inhabitants most often exceeded the debt criterion of the budget responsibility rule. The proportion of municipalities with more than 1,000 inhabitants that exceeded the debt criterion decreased compared to 2020. The largest municipality that exceeded the debt

[17] The total of 123,781 people live in municipalities where the budgetary responsibility rule indicator exceeds 100% (224 municipalities, i.e. 3.6% of the total). This represents approximately 1.16% of the Czech population (in 2020 the figure was only 109,756 people, i.e. 1.03% of the Czech population).
[18] MF CR (2022): Information on the Monitoring of Local and Regional Authorities' Finances for 2021 (in Czech).

criterion in 2021 was Český Krumlov with 12,788 inhabitants. However, its ratio of debt to average revenues fell by 2.2 pp year on year to 62.1%. The city of Olomouc similarly reduced its debt-to-revenue ratio from 64.2% in 2020 to 59.1% in 2021. The best-performing regional capital in this regard is Jihlava, whose ratio of debt to average revenues was just 5.4% in 2021. By contrast, besides Olomouc, Liberec with its debt-to-average revenue ratio of 59% in 2021 is also close to the 60% level.

Chart 6 Number of municipalities exceeding the 60% debt criterion of the budget responsibility rule



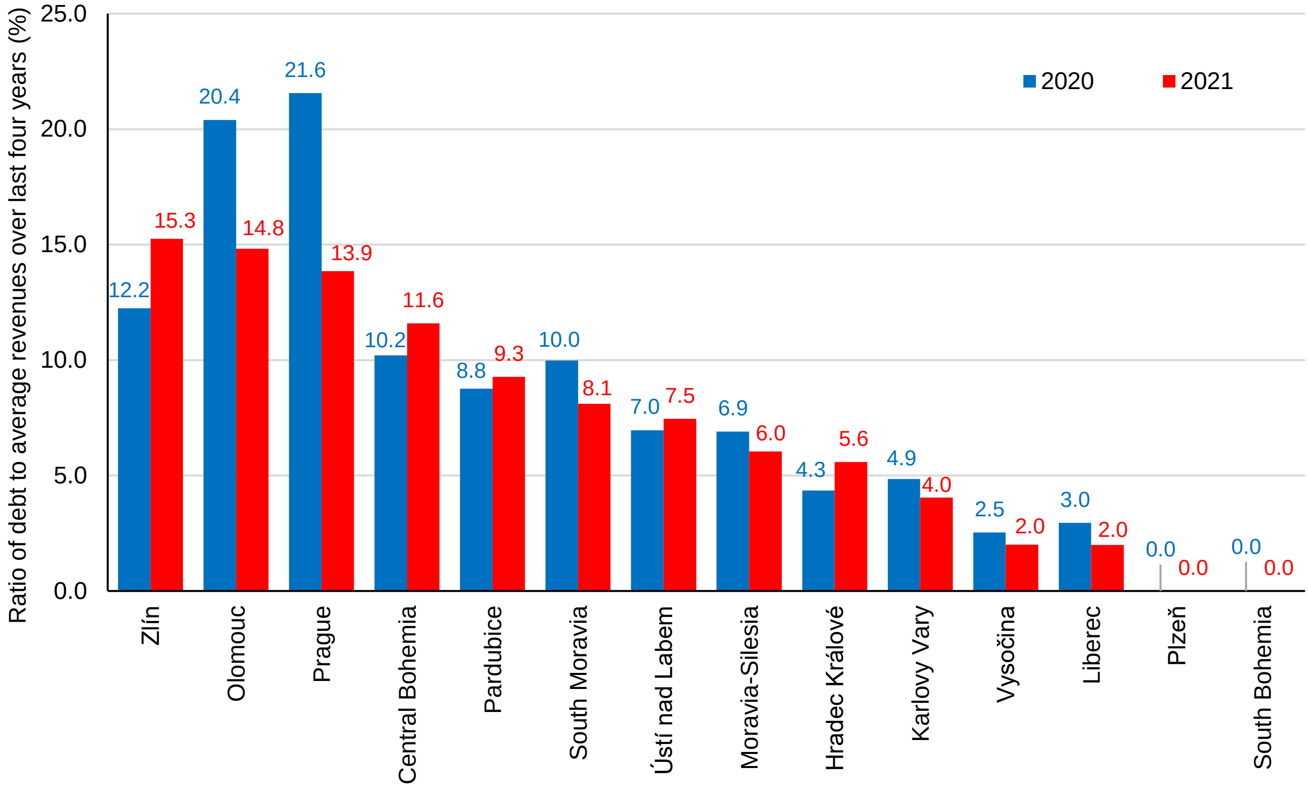
Source: MF CR (2022): Information on the Monitoring of Local and Regional Authorities' Finances for 2021; CFC calculations.

Chart 6 shows that the largest number of municipalities in absolute terms exceeding the debt criterion of the budgetary responsibility rule lie in Central Bohemia, which, however, also has the largest number of municipalities of all the regions. The largest percentage of municipalities exceeding the debt criterion of the budgetary responsibility rule are located in the Olomouc region (14.7% of municipalities). Central Bohemia, South Moravia, Pardubice and Moravia-Silesia also recorded more than 10% of municipalities exceeding the debt criterion of the budgetary responsibility rule (13.6%, 11.8%, 11.1% and 10.7% respectively). The best performers in this respect were the municipalities in the Liberec and Karlovy Vary regions (2.3% and 3.8% respectively).

At the level of regions, the debt criterion of the budgetary responsibility rule is fulfilled by a comfortable margin. Zlín reports the highest ratio of debt to average revenues over the last four years (15.3%, up 3 pp on 2020). It is followed by the Olomouc region (14.8%) and the City of Prague[19] (13.9%), which reduced their debts levels compared to the previous year. By contrast, the regions of South Bohemia and Plzeň had absolutely no debt in 2021.[20] Compared to 2020, seven regions reported a drop in the ratio of debt to average revenues over the last four years. The largest increase was recorded by Central Bohemia (1.4 pp). The figures are shown in Chart 7.

[19] Prague is accorded the status and powers of both a municipality and a region – see Act No. 131/2000 Coll., on the City of Prague (in Czech).
[20] See MF CR (2022): Information on the Monitoring of Local and Regional Authorities' Finances for 2021 (in Czech).

Chart 7 Regions by debt-to-average revenue ratio over the last four years, 2020 versus 2021



Source: MF CR (2021): Information on the Monitoring of Local and Regional Authorities' Finances for 2020; MF CR (2022): Information on the Monitoring of Local and Regional Authorities' Finances for 2021; CFC calculations.
Note: The calculations in the chart may be subject to inaccuracies due to rounding.

Besides the budgetary responsibility rule set by the Act, the Ministry of Finance monitors another two indicators in the case of municipalities and regions. These indicators, for which the Ministry sets recommended levels, are the ratio of loans and advances to total assets, and total liquidity. The Ministry considers them to be important because, unlike the budgetary responsibility rule, they contain information about the assets and overall liabilities of municipalities and regions. Although these indicators are not directly related to the Act, the CFC decided to take them into account as well, since they provide a fuller picture of the finances of municipalities and regions.

The Ministry of Finance recommends that the ratio of loans and advances to total assets, which expresses the proportion of assets covered by third-party finances, be no higher than 25% in the case of municipalities and regions. A total of 190 local and regional authorities (LRAs) – 181 municipalities (2.9% of all municipalities) and nine regions – exceeded this level in 2021, a year-on-year increase of 25 LRAs. In all, 126 of the municipalities exceeding the debt criterion of the budgetary responsibility rule are not compliant with the required ratio of loans and advances to total assets, i.e. 21.8% of the municipalities exceeding the debt criterion, or 2.0% of all municipalities. The municipalities exceeding both criteria are home to 0.7% of the population of the Czech Republic. The municipalities of Turovice and Prameny report the highest ratios of loans and advances to total assets (574.1% and 232.1% respectively). No other municipality exceeded the 100% level.[21]

The total liquidity indicator, which expresses the ratio of current assets to short-term liabilities, indicates to what extent a municipality is able to fulfil its short-term obligations. The Ministry of Finance recommends that this ratio lie between 0 and 1. A total of 72 municipalities (i.e. 1.2%) are not compliant with this recommendation. This represents a year-on-year decrease of 12 municipalities.

In 2021, the category of LRAs that exceeded the limits on all three monitored indicators simultaneously and were therefore classified by the Ministry of Finance as LRAs with a high level of financial risk, contained five municipalities (as against seven in 2020).

[21] A ratio of loans and advances to total assets in excess of 100% means that the municipality reports negative equity.

The total number of people living in these municipalities is 1,925, or less than 0.02% of the total Czech population (in 2020 the figure was 3,409). The limits on the monitored indicators were exceeded mainly due to the deferral of loan repayment in accordance with repayment schedules. The municipalities concerned often have only low immediately available financial reserves and their finances may therefore be exposed to the following risks:

a) insufficient funds for the management and repair of tangible fixed assets,
b) the need to cover suddenly arising expenditures,
c) non-compliance with the conditions of subsidies provided/promised (including ensuring the sustainability of the project for the required period).

Aside from the municipalities that exceed the limits on all three indicators mentioned above, the municipalities of Prameny and Turovice are also facing serious financial problems. They do not exceed the limits on all three monitored indicators simultaneously, but they do report the highest ratios of loans and advances to total assets of all the municipalities in the Czech Republic.

Conclusion: As of 31 December 2021, a total of 578 municipalities and no regions exceeded the debt criterion defined in Section 17(1) of the Act. In 2021, a total of ten municipalities were non-compliant with the obligation to reduce their debt by the minimum level defined in the Act. However, all of these municipalities took remedial action in 2022.

Summary

The Czech Fiscal Council states that in 2021:

a) the general government debt rule (Section 14 and Section 16 of the Act) was complied with,

b) the procedure for determining total general government expenditure and deriving the state budget and state funds expenditure framework was followed,

c) compliance with the structural deficit cap cannot be assessed, because the second amendment of the Act set no such cap for 2021,

d) a total of 578 municipalities exceeded the 60% limit on local or regional authority debt (Section 17(a) of the Act),

e) a total of ten municipalities were non-compliant with the obligation to reduce their debt in 2021 by the set minimum level, but all of them took remedial action within the stipulated deadline,

f) the Ministry of Finance did not have to suspend the transfer of any local or regional authority's share in tax revenue.

Furthermore, the Czech Fiscal Council states that the relaxation of the structural balance rules implemented through an amendment of the Act significantly reduces the effectiveness of the fiscal rules and moves public budgets further away from a return to a sustainable level.