The Czech
Fiscal Council

Report on Compliance with the Rules of Budgetary Responsibility for the Year 2020

September 2021

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Introduction

The Czech economy, like most economies around the world, was hit hard by the COVID-19 pandemic in 2020. The ensuing economic contraction and the revenue and expenditure measures taken to mitigate the negative impacts of the crisis gave rise to a large public finance imbalance. All this affected the levels of the indicators monitored in the context of the various fiscal rules. The public finance imbalance persisted into 2021 and widened even further, largely as a result of changes made to tax and expenditure policies. The relative importance of support programmes, taking the form of one-off and temporary measures, diminished. After the pandemic ends, these support programmes will disappear and no longer burden public finances, while other measures will remain in place and the resulting imbalance will have to be addressed in the future with strong fiscal restriction.

This Report on Compliance with the Rules of Budgetary Responsibility (the "Report") contains an assessment of compliance with the fiscal rules in 2020. Preparing the Report is one of the main duties of the Czech Fiscal Council (CFC) set out in Act No. 23/2017 Coll., on the Rules of Budgetary Responsibility, as amended (the "Act"). Although the Report evaluates the information relating to 2020 only, it also examines the period before 2020 and takes a look at current and expected future trends.

The Act defines the fiscal rules and is crucial for evaluating compliance with them. In 2020, it underwent two amendments that will affect the assessment of the fiscal rules for almost a decade to come. The two amendments relaxed the maximum permitted structural deficits and significantly moved the timescale over which public finances should return to a sustainable level. The form of these changes and the way they were discussed reveal a misunderstanding of the logic of the fiscal rules, for which stability and transparency are key. The result is that the fiscal rules are being adjusted to fiscal policy and not vice versa. Going forward, this will limit the functionality of the fiscal rules in achieving their primary objective of ensuring sustainable public finances.

The Report is divided into four main sections, the first of which outlines the economic situation and general government finances[1] and the other three evaluate compliance with each of the fiscal rules. The text is supplemented with three thematic boxes. The first examines the impact of the relaxation of the expenditure rule on the expected path of public debt, the second provides an international comparison of the expected evolution of fiscal policy, and the last analyses the effect of the one-off budget compensation provided to municipalities.

[1] The central term we use in the text is "general government" (S.13 in ESA 2010). In ESA 2010, "general government" is subdivided into "central government" (S.1311), "state government" (S.1312), "local government" (S.1313) and "social security funds" (S.1314).

1 General government finances

The COVID-19 pandemic caused real GDP to decline by 5.8% year on year and the economy to slip into recession after several years of growth (2014–2019).[2] The biggest contributors to the decline were household final consumption expenditure and investment. Government expenditure was the only item to mitigate the decline in GDP. After three years with a positive output gap (2017–2019), the economy fell below its potential output level. The economic contraction was also reflected in general government finances. Following surpluses in 2016–2019, the sector recorded a deficit of 6.1% of GDP. The structural balance reached –2.9% and was thus negative for the second year in a row. The events of 2020 caused the debt ratio to rise by 7.8 pp compared with 2019, to 37.8% of GDP.

According to the forecast of the Czech Ministry of Finance (MF CR),[3] GDP will grow by 3.2% in 2021, with investment and household expenditure contributing most to the growth. The output gap is expected to be negative (at –0.6%). The general government deficit will probably be even larger than in 2020, reaching 7.7% of GDP; the structural deficit is projected at 6.1% of GDP.

Although the pandemic is expected to recede gradually in 2021 and further economic growth is forecasted for 2022–2024, the predicted path of public finances is not in line with that. The general government deficit will stay above 4% of GDP. The structural deficit will not improve sufficiently and will stand at 4.6% of GDP in 2024. According to the Ministry of Finance forecast, the sector's debt ratio will reach 51.8% of GDP in 2024.

This path is a consequence of two amendments to the Act that significantly softened the fiscal expenditure rule. Box 1 describes these amendments and their impacts on the expected path of public debt. Generally speaking, the amendments to the Act imply that, rather than public budgets adjusting to the fiscal rules, the latter will be relaxed according to the government's current needs. The effectiveness of the fiscal rules themselves will thus be reduced, increasing the likelihood of public finance problems arising in the medium term.

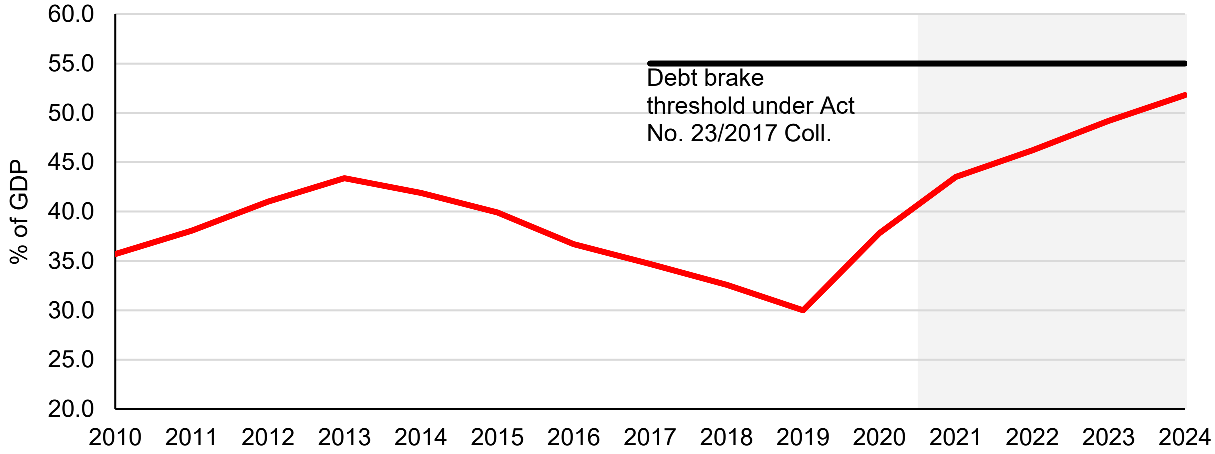
2 The debt rule

The debt rule is defined in Sections 13–16 of the Act. Specifically what is monitored is the level of general government debt minus the state debt financing reserve, expressed as a percentage of GDP. If the debt defined in this way exceeds 55% of GDP (the "debt brake threshold"), the measures set out in Section 14 of the Act will be applied. The application of these measure would greatly reduce the government's ability to use fiscal policy actively for macroeconomic stabilisation purposes and would restrict the activity of many general government organisations. It would also send a negative signal to the financial markets. If the debt exceeds 60% of GDP, the government will propose measures leading to a decrease of this level pursuant to Section 16 of the Act.[4]

The value of the debt rule indicator as of 31 December 2020 was announced at 38.09% of GDP in a CFC communication of 8 April 2021, based on data from the Czech Statistical Office and the Ministry of Finance. Owing to a revision of the national accounts, the nominal GDP figure for 2020 was later increased. This caused the general government debt ratio minus the state debt financing reserve to decrease to 37.8% of GDP. The revision therefore did not cause either of the above reference values defined in the Act to be exceeded.

[2] MF CR (August 2021): Macroeconomic Forecast of the Czech Republic.
[3] MF CR (August 2021): Macroeconomic Forecast of the Czech Republic.
[4] 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 (2015): Draft State Final Accounts of the Czech Republic for 2014, section E. State Debt Management Report, MF CR (April 2017–2021): Convergence Programme of the Czech Republic, MF CR (August 2021): Macroeconomic Forecast of the Czech Republic, CNB (2021): Government Financial Statistics; CFC calculations.

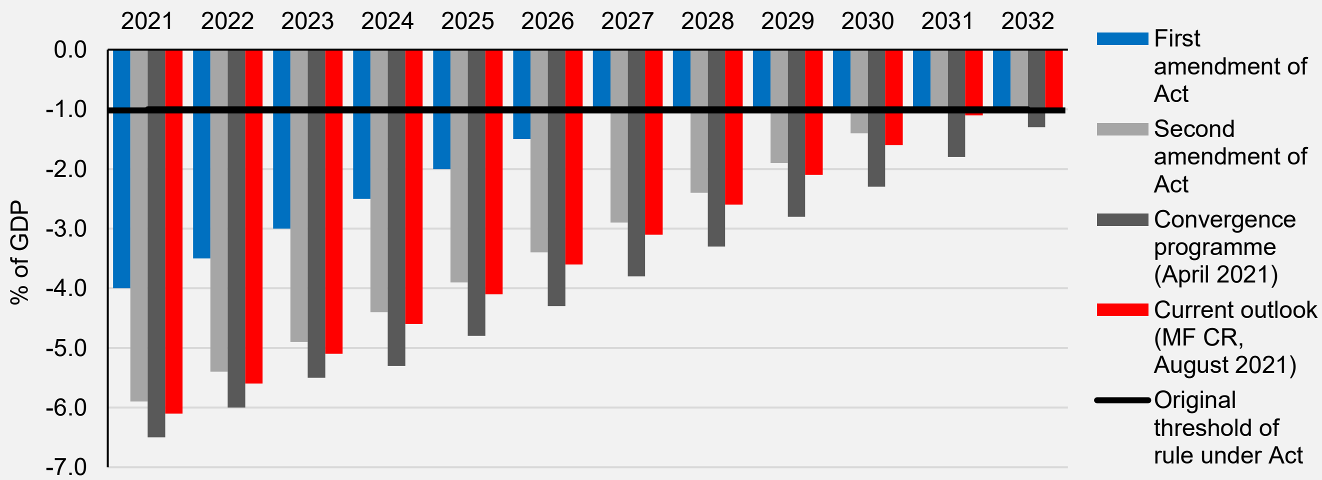
Chart 1 shows the evolution of this indicator in the period 2010–2024. The Ministry of Finance forecast predicts a figure of 51.8% of GDP for 2024.

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 2020.

Box 1 The double amendment of the Act on the Rules of Budgetary Responsibility and its debt impacts

The first amendment of the Act[5] was approved in April 2020 together with an increase in the government budget deficit for 2020 to CZK 300 billion. This amendment concerned the creation of fiscal space for 2021 – it raised the cap on the structural deficit (the reference value for the fiscal expenditure rule) from 1% to 4% of GDP (see Chart B1.1). In subsequent years, public finances were to be consolidated by means of a reduction of the structural deficit at a rate of 0.5% of GDP a year (i.e. approximately CZK 30 billion a year; measured by the ratio of the structural deficit to GDP). Under this first amendment, the structural deficit was to return to 1% in 2027. The CFC unanimously rejected this change to the legislation, stating that one-off measures should be used for 2021 as well, so that the extraordinary fiscal support measures targeted at supporting the economy in the context of the COVID-19 pandemic were not mixed with those which would affect the structure of public finances in the long term. The Chamber of Deputies passed this amendment on 22 April 2020 after it was vetoed by the Senate.

Chart B1.1 The general government structural balance (projection for 2021–2032)



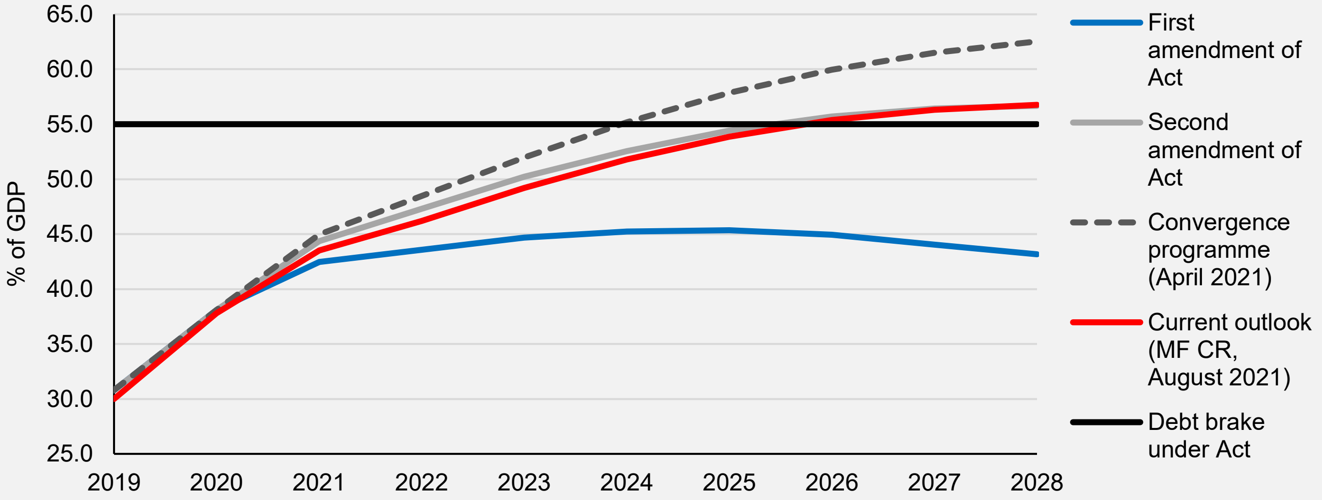
Source: MF CR (April 2021): Convergence Programme of the Czech Republic, MF CR (January, April and August 2021): Macroeconomic Forecast of the Czech Republic; CFC calculations.
Note: MF CR projection for 2021–2024, CFC projection for 2025–2032.

[5] See https://www.psp.cz/sqw/sbirka.sqw?cz=207&r=2020 (in Czech).

The second amendment of the Act,[6] approved on 22 December 2020, was associated with the adoption of a "tax package". Unlike the first amendment, the second 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 2021 can be estimated only passively, on the basis of the effects of the tax package and macroeconomic trends (in December 2020 the estimated structural deficit for 2021 was 5.9% of GDP). All that remained in force was the future reduction of the structural deficit at a rate of 0.5% of GDP a year. In practice, this meant that the return to the statutory level of 1% was shifted by the second amendment from 2027 to 2031 (see Chart B1.1).

The two amendments naturally changed the outlook for the path of Czech government debt. The first amendment led to an expected gradual increase in the government debt-to-GDP ratio to 45.3% in 2024. Thereafter, the debt level would then have decreased steadily back below 45%. The second amendment affected the government debt outlook much more strongly, as it lengthened the timescale of the return to the 1% structural deficit rule. While the first relaxation did not signal that the debt brake of 55% of GDP would be hit during the 2020s, the second resulted in the cap on the debt rule being reached in 2026. As the second amendment shifted the return to a 1% structural deficit to 2031, this relaxation implied further modest growth in government debt even after the debt brake was hit. The second amendment therefore de facto not only disabled the structural deficit rule for 2021, but also signalled the future abandonment of the 55% of GDP government debt rule (see Chart B1.2).

Chart B1.2 General government debt (projection for 2021–2028)



Source: MF CR (April 2021): Convergence Programme of the Czech Republic, MF CR (January, April and August 2021): Macroeconomic Forecast of the Czech Republic; CFC calculations.
Note: MF CR projection for 2021–2024, CFC projection for 2025–2028.

The Convergence Programme gave rise to a further change in the debt outlook.[7] The estimated structural deficit for 2021 contained in the Convergence Programme is 6.5%, assuming a constant rate of consolidation in future years. Even this seemingly small difference had quite a large effect on the level of debt in future years – the economy was at risk of breaching the 55% of GDP level already in 2024 and the Maastricht debt criterion of 60% of GDP would have been reached in 2026 in the absence of a more ambitious consolidation strategy.

The current government debt outlook, based on the August 2021 macroeconomic forecast,[8] is slightly better for 2021–2024 than both the outlook based on the Convergence Programme and that based on the second relaxation of the Act. The difference in the debt level for 2021 compared with this outlook is almost one percentage point (43.5% versus the original 44.4%) and gradually disappears in subsequent years. The better government debt outlook is due to two factors. The first is a retrospective revision of the nominal GDP data which reduced the debt-to-GDP ratio for 2019 from 30.8% to 30.0% and that for 2020 from 38.1% to 37.8% given the same absolute debt level, which cannot be revised retrospectively. The second factor consists primarily in a combination of higher expected GDP growth, a higher inflation rate and a lower unemployment rate. Public budgets should thus receive CZK 99 billion and CZK 61 billion more in taxes in 2021 and 2022 respectively than previously expected.

According to the current outlook, the structural public finance deficit should thus reach 6.1% of GDP in 2021 and return to the statutory reference value in 2031. The year when the debt brake will be hit has moved to 2026.

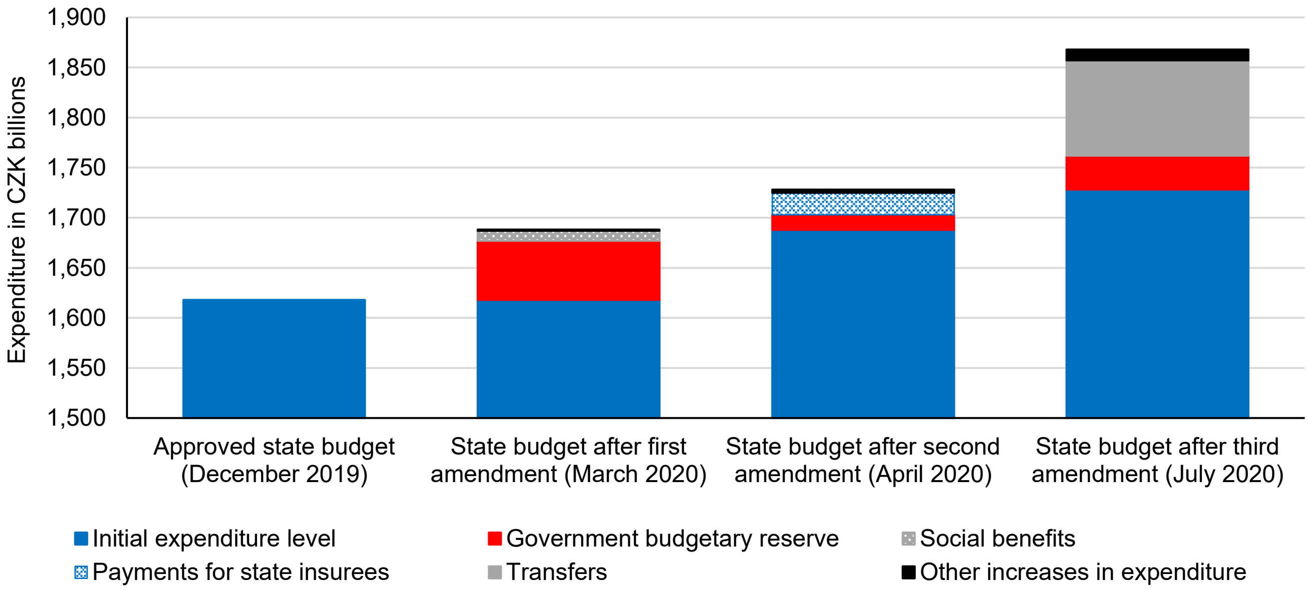
[6] See https://www.psp.cz/sqw/sbirka.sqw?cz=609&r=2020 (in Czech).
[7] MF CR (April 2021): Convergence Programme of the Czech Republic.
[8] MF CR (August 2021): Macroeconomic Forecast of the Czech Republic.

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

The state budget for 2020 and the budgets of other relevant general government entities were prepared during 2019. In April 2019, the Ministry of Finance set total general government expenditure for 2020 at CZK 2,436 billion and the state budget and state funds expenditure framework (including the EU) for 2020 at CZK 1,598 billion (see Table 1).[9] During the preparation of the state budget, the state budget and state funds expenditure framework was revised to CZK 1,658 billion in September 2019 in accordance with Section 8 of Act No. 218/2000 Coll., on Budgetary Rules. The increase was made possible primarily by higher expected tax and social insurance revenue, other revenue and changes to the estimate of revenue from European Union funds and financial mechanisms.[10] The total approved level of state budget and state funds expenditure was CZK 1,634 billion, approximately 1.5% lower than the revised framework. 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. 355/2019 Coll., on the State Budget of the Czech Republic for 2020, of 4 December 2019 set state budget expenditure at CZK 1,618 billion.[11] This law underwent three amendments during the budget period. Expenditure was thus progressively raised to CZK 1,865 billion, primarily in non-investment areas. Chart 2 shows the structure of the gradual increase in expenditure.

Chart 2 Impacts of amendments to the State Budget Act on expenditure



Source: MF CR (2021): Draft State Final Accounts of the Czech Republic for 2020: C – Report on the State Budget Results; CFC calculations.
Note: The chart excludes a decrease in expenditure of approximately CZK 4.4 billion under the first budget amendment (primarily a reduction in investment purchases and a reduction in expenditure associated with fare discounts). *Initial expenditure level* indicates planned expenditure under the previous legislation/amendment. *Transfers* comprises non-investment and, to a smaller extent, investment transfers to businesses, state funds, municipalities and regions and so on. *Other increases in expenditure* consist, for example, of increases in debt service expenditure (first and second amendments) and other capital expenditure (third amendment).

Claims arising from unconsumed expenditure amounted to CZK 130 billion at the start of 2020. CZK 109 billion in claims arising from unconsumed expenditure was employed in budgets or terminated in 2020. CZK 81 billion was actually drawn down. However, the amount of undrawn 2020 expenditure transferred to claims arising from unconsumed expenditure was higher, so claims arising from unconsumed expenditure rose to CZK 175 billion as of 1 January 2021.

[9] MF CR (2019): General Government Budgetary Strategy of the Czech Republic for 2020–2022 (in Czech).
[10] MF CR (2019): Documentation on the Draft Act on the State Budget of the Czech Republic for 2020: B – Report on the State Budget of the Czech Republic for 2020 (in Czech).
[11] MF CR (2021): Draft State Final Accounts of the Czech Republic for 2020 – C. Report on the State Budget Results (in Czech).

Actual general government expenditure totalled CZK 2,685 billion and actual state budget and state funds expenditure CZK 1,877 billion in 2020. This is CZK 219 billion more than the figure in the revised framework.

Table 1 Key expenditure rule indicators and the figures actually recorded in 2020 (CZK billions unless stated otherwise)

	Budgetary strategy (April 2019)	Draft state budget (September 2019)	Approved state budget (December 2019)	Actual figure (August 2021)
General government expenditure	2,436			2,685
SB and SFs expenditure framework, including EU	1,598	1,658		
SB			1,618	1,843
SFs			137	170
Transfers from SB to SFs			121	136
SB and SFs, total			1,634	1,877
GDP at current prices	5,839	5,880		5,695
Structural balance (% of GDP)		-0.2		-2.9
Output gap (%)		0.6		-3.1

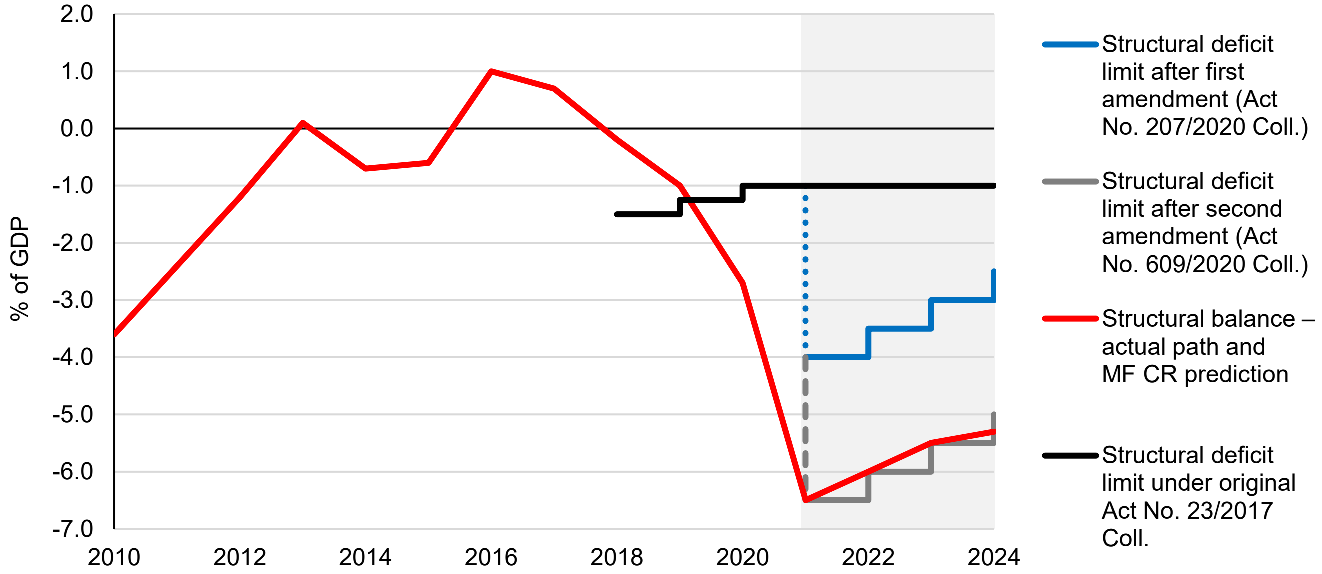
Source: MF CR (2019): General Government Budgetary Strategy of the Czech Republic for 2020–2022; MF CR (2019): Report on the State Budget of the Czech Republic for 2020 and Medium-term Outlook for the State Budget of the Czech Republic for 2021 and 2022; MF CR (2021): State Treasury Monitor; MF CR (2021): Treasury Performance for January–December 2020; MF CR (August 2021): Macroeconomic Forecast of the Czech Republic; CZSO (2021): National Accounts Database; CFC calculations.
Note: SB = state budget, SFs = state funds.

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. For 2020, the Act sets a maximum permissible deficit of 1% of GDP for 2020. However, a value of 0.75% of GDP was used to derive the expenditure framework. This was equal to the current value of the Medium-Term Objective.[12] The actual structural deficit was 2.9% of GDP (see Chart 3) and thus exceeded the aforementioned value used to derive the frameworks.

Large structural deficits are predicted for future years as well, as is evident from Chart 3. Their high levels and slow rate of decrease are also apparent from the international comparison contained in Box 2.

[12] See Economic and Financial Committee (EFC): Specifications on the Implementation of the Stability and Growth Pact and Guidelines on the Format and Content of Stability and Convergence Programmes.

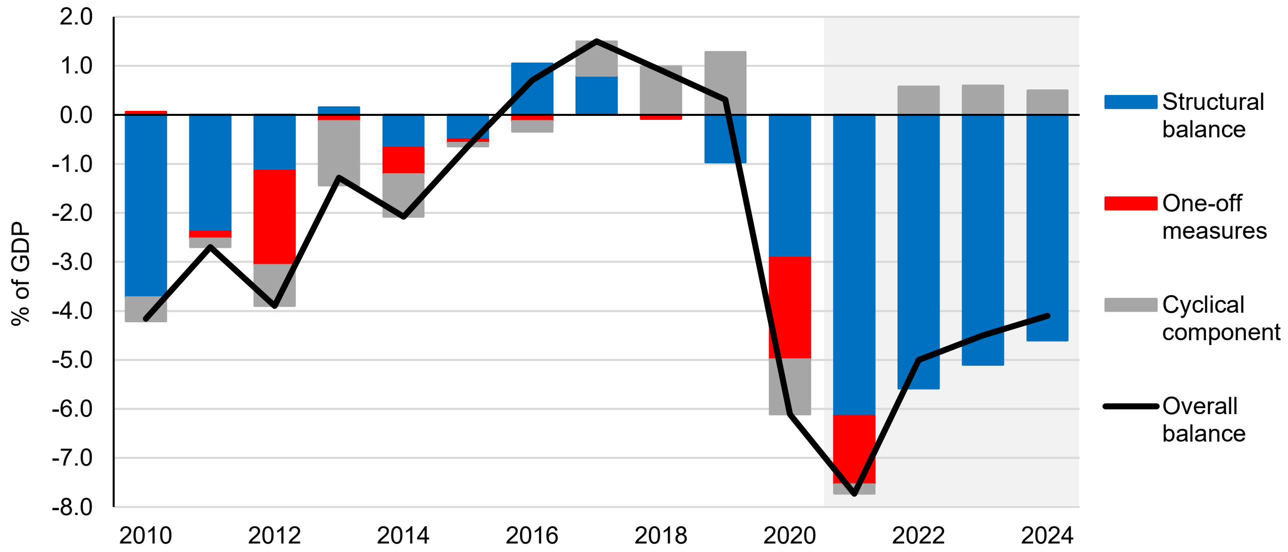
Chart 3 The general government structural balance



Source: MF CR (July 2019, September 2020, August 2021): Macroeconomic Forecast of the Czech Republic; MF CR (April 2021): Convergence Programme of the Czech Republic; CFC calculations.

Chart 4 provides the breakdown of the overall general government balance. It shows that the dominant part of the deficits (past and expected) does not consist of the one-off and temporary measures taken in connection with the COVID-19 pandemic and the cyclical part, but involves a permanent change in the level of taxes and expenditure that cannot be explained by the COVID-19 pandemic.

Chart 4 Decomposition of the overall general government balance



Source: MF CR (September 2020, January and August 2021): Macroeconomic Forecast of the Czech Republic.

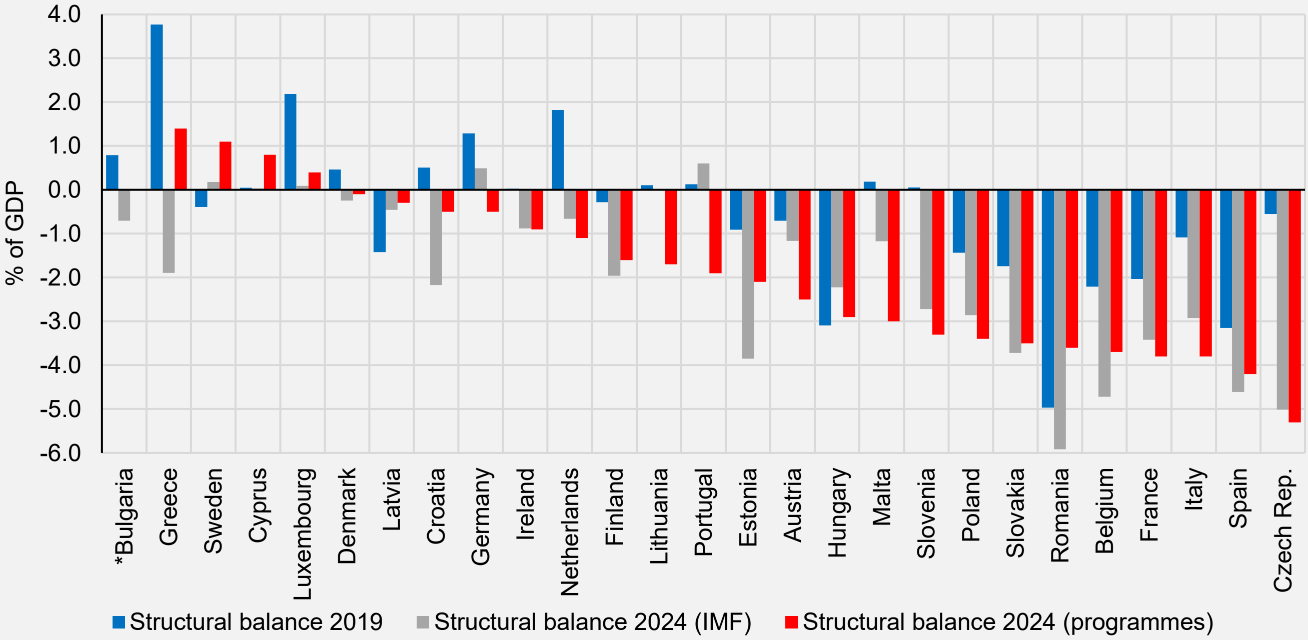
Conclusion: The CFC states that the procedure for determining total general government expenditure and deriving the state budget and state funds expenditure framework was followed in the process of approval of the state budget and state funds expenditure level for 2020. As a result of the COVID-19 pandemic, though, actual state budget and state funds expenditure significantly exceeded the approved framework and the structural deficit was also above the limit used to derive it. However, the spending in excess of the framework will not affect the value of the corrective part, which may affect the expenditure framework in future years because the current version of the Act abolished the application of the corrective part in 2021 and 2022.

Box 2 International comparison of the structural balance and public debt outlooks (2021–2024)

Box 1 presented the outlooks for the two main domestic fiscal rules in the context of the double relaxation of the Act. Box 2 examines the two main public finance indicators from the perspective of an international comparison in 2021–2024. The comparison is based on two data sources: the IMF's half-yearly outlook and the convergence and stabilisation programmes submitted by the EU countries to the Commission in April.[13] The convergence and stabilisation programme data cover the period 2021–2024 and also include updated figures for 2019 and 2020. The IMF data are available for the period up to 2026. However, this box will focus on the period 2021–2024 for the sake of comparability of the two data sources and because increasing the outlook horizon increases the uncertainty and hence the potential inaccuracy of the international comparison.

The Czech structural balance from the convergence programme perspective matches the IMF outlook almost exactly. The difference between the IMF's estimate and the data from the Czech Republic convergence programme differ only for 2024, when the IMF predicts a structural deficit of 5.0% of GDP for the Czech Republic while the Czech convergence programme predicts an even bigger deficit (5.3% of GDP). According to the IMF outlook, the Czech structural deficit will be the second worst behind Romania (5.0% of GDP for the Czech Republic versus 5.9% of GDP for Romania). According to the comparison of the programmes, the planned Czech structural deficit of 5.3% will be by far the largest in the entire EU (see Chart B2.1). Spain expects the second largest structural deficit 4.2% of GDP, but this is more than one percentage point lower than the Czech figure.

Chart B2.1 Structural balances in EU countries in 2019 and their projected levels in 2024



Source: IMF (April 2021): World Economic Outlook, convergence and stabilisation programmes (April 2021); CFC calculations.
Note: Countries are presented in order of estimated structural balances in 2024 according to programmes. *Convergence programme data are not available for Bulgaria for 2024.

The comparison also reveals a link between future and pre-crisis structural balances. Nine of the 13 EU countries that reported structural surpluses in 2019 are planning structural deficits of no more than 1% of GDP in 2024. Three countries (Greece, Cyprus and Luxembourg) even expect structural surpluses. The Czech Republic's history of structural imbalances, which the CFC has been drawing attention to ever since it was established, is therefore an important factor of the extreme structural deficit expected for 2024.

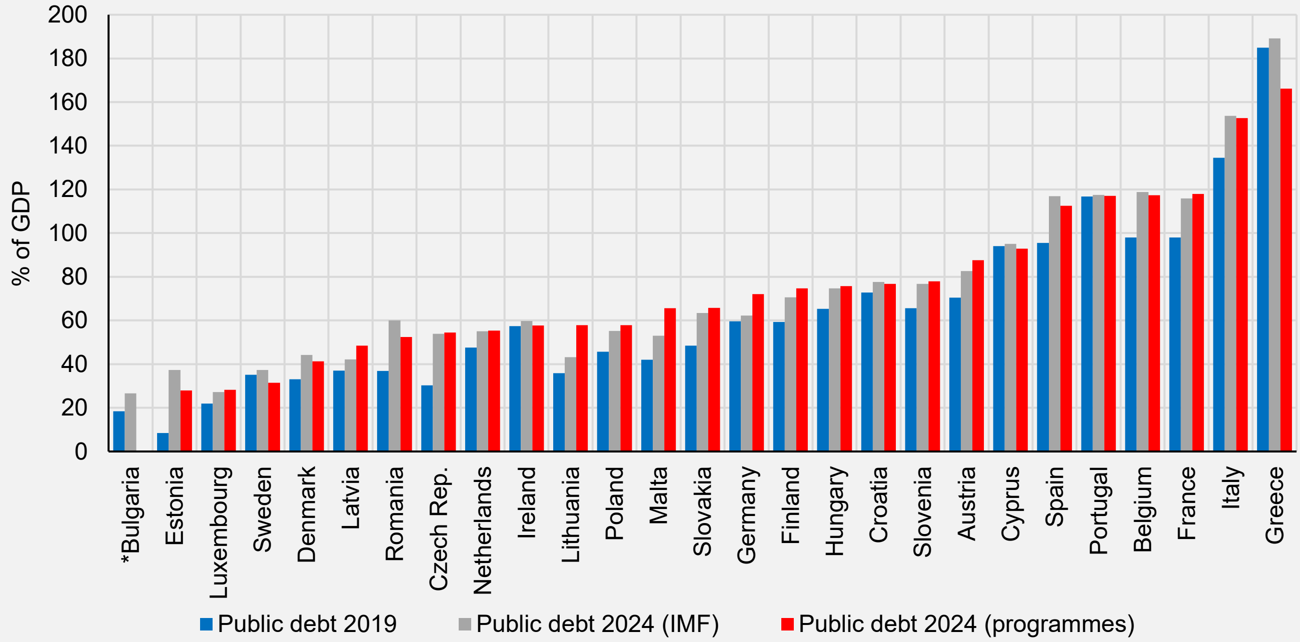
Larger differences can be seen between the IMF data and the programmes as regards the expected path of public debt as a percentage of GDP. For the Czech Republic, though, the difference is small: in 2024 the IMF expects a debt ratio of 53.9%, while the convergence programme expects 54.5% (see Chart B2.2). However, it is clear from both sources used for our international comparison that while the growth in the Czech debt is close to the EU average in 2020 and 2021, it is extremely high in subsequent years (see Chart B2.4). By comparison with 2019, when the debt ratio reached 30.2% of GDP, the IMF is forecasting an increase in debt of 23.7 pp, the

[13] The figures for the Czech Republic may thus differ from the data contained in sections 1–3, which use more recent data taken from MF CR (August 2021): Macroeconomic Forecast of the Czech Republic.

second largest behind Estonia (28.9 pp). In terms of the comparison of programmes, the rise in the Czech debt level of 24.3 pp is the highest in the entire EU (see Chart B2.3).

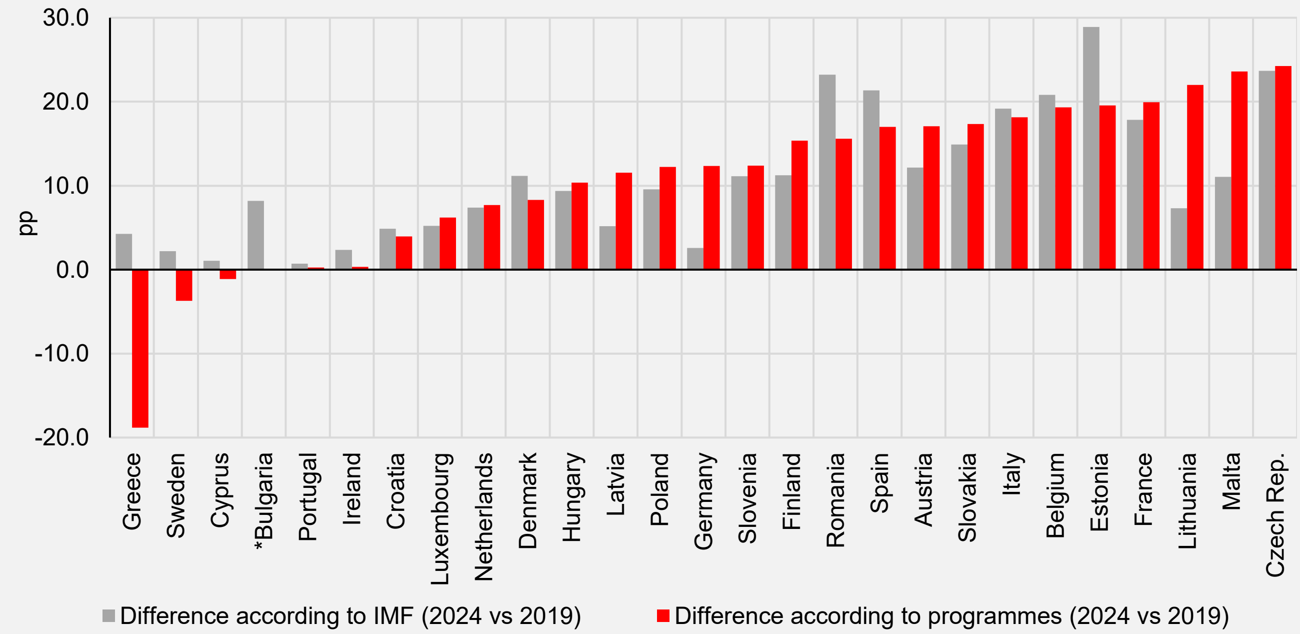
Eleven countries of the EU 27 expect a decline in their debt in 2024 relative to 2020. For the countries expecting their debt to rise between 2020 and 2024, the average increase is 5.7 pp. The Czech debt path therefore seems extreme from all perspectives and is an outlier in our international comparison.

Chart B2.2 Public debt in EU countries in 2019 and its projected levels in 2024



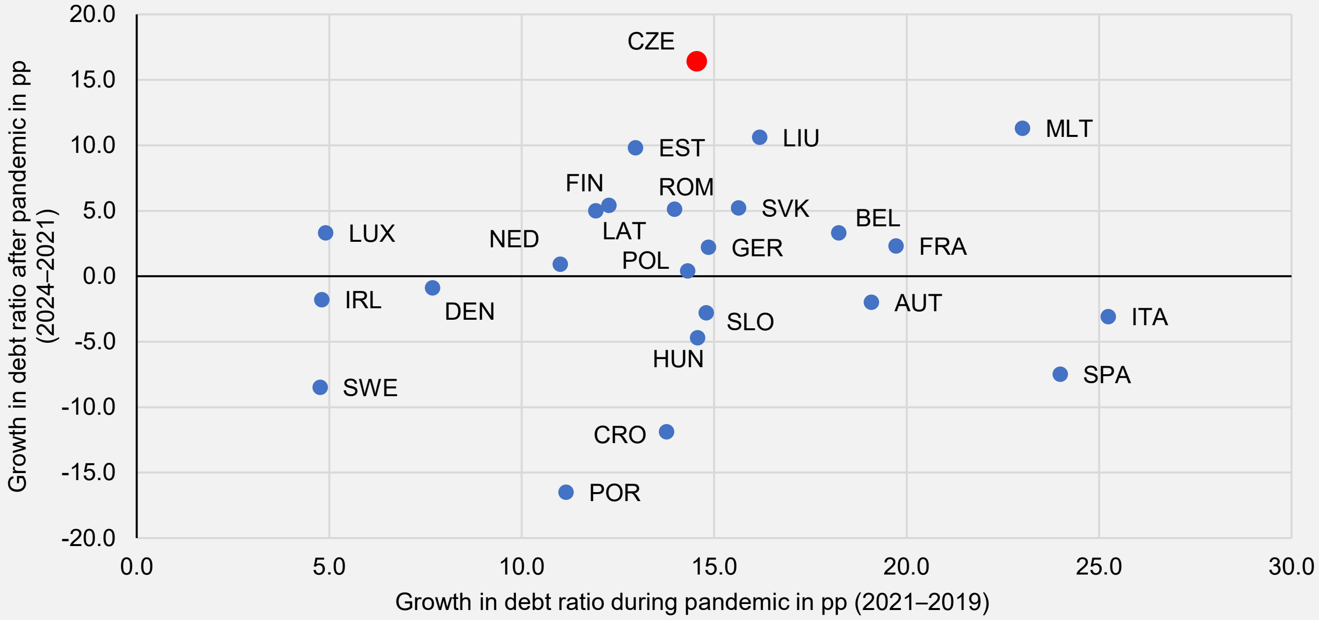
Source: IMF (April 2021): World Economic Outlook, convergence and stabilisation programmes (April 2021); CFC calculations.
Note: Countries are presented in order of estimated public debt in 2024 according to programmes. *Convergence programme data are not available for Bulgaria for 2024.

Chart B2.3 Projected differences in public debt as a percentage of GDP between 2024 and 2019



Source: IMF (April 2021): World Economic Outlook, convergence and stabilisation programmes (April 2021); CFC calculations.
Note: Countries are presented in order of estimated change in public debt in 2024 according to programmes. *Convergence programme data are not available for Bulgaria for 2024.

Chart B2.4 Comparison of growth in public debt-to-GDP ratios during and after the COVID-19 pandemic



Source: Convergence and stabilisation programmes (April 2021); CFC calculations.

4 Local and regional government finances*

The Constitution of the Czech Republic defines municipalities and regions as local and regional authorities.[14] 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 2016–2020

The local government subsector[15] has reported budget surpluses in the last five years and has thus contributed to better financial results of the overall general government sector each year. In 2020, the total revenue of the subsector was CZK 752.1 billion, up CZK 34.5 billion on the previous year. Local government revenue accounted for 32.2% of total general government revenue and local government expenditure for 27.5% of total general government expenditure. The local government surplus fell by CZK 23.1 billion year on year to CZK 14.5 billion in 2020, amounting to 0.3% of GDP. Table 2 contains the relevant figures.

Table 2 Local government finances in the Czech Republic 2016–2020

	2016		2017		2018		2019		2020	
	CZK bn	% of GDP	CZK bn	% of GDP	CZK bn	% of GDP	CZK bn	% of GDP	CZK bn	% of GDP
Revenue	543.9	11.3	589.9	11.5	659.1	12.2	717.6	12.5	752.1	13.3
Expenditure	494.2	10.3	548.0	10.7	635.5	11.7	680.0	11.8	737.6	13.0
Balance	49.7	1.0	41.9	0.8	23.6	0.4	37.6	0.7	14.5	0.3

Source: CZSO (2021); CFC calculations.

[14] 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 (2021): "Statement of sources and uses of cash of territorial self-governing units". In this Report, we use "local and regional authorities".
[15] 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.

Like other general government units, local and regional authorities were negatively affected by the economic impacts of the COVID-19 pandemic. The economic contraction affected tax revenues. Moreover, the design of certain stabilisation programmes, in particular the compensatory bonus, also reduced revenues. This shortfall was offset in the case of municipalities by a CZK 13.4 billion transfer from the state budget (a one-off non-refundable contribution under an amendment to Act No. 159/2020 Coll. designed to compensate municipalities for the drop in their tax revenues resulting from the COVID-19 pandemic; hereinafter the "contribution"). Without this compensation, the subsector's overall balance would have been just CZK 1.1 billion. Box 3 analyses the effect of the contribution on municipal finances in more detail.

Local government debt recorded a modest rise of CZK 2.2 billion in 2020 (see Table 3). However the overall debt stood at CZK 86.8 billion at the end of 2020, accounting for just 4% of total general government debt.

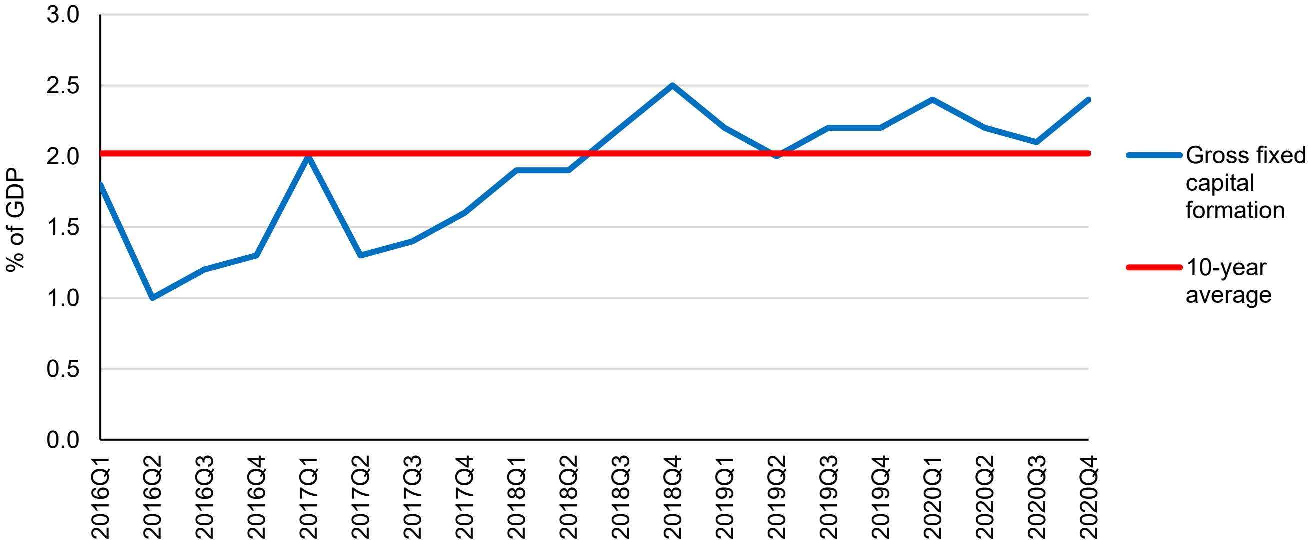
Table 3 Local government debt in the Czech Republic 2016–2020

	2016	2017	2018	2019	2020
Debt (CZK billions)	89.5	84.9	84.0	84.4	86.8
Ratio to GDP (%)	1.9	1.7	1.6	1.5	1.5
% of total general government debt	5.1	4.9	4.8	4.8	4.0

Source: CZSO (2021); CFC calculations.

On the positive side, a high level of investment was maintained in 2020. At CZK 129 billion, it was CZK 31.3 billion above the ten-year average for 2011–2020 (see Chart 5).[16] Had municipalities not received the contribution, investment might theoretically have been up to 10.4% lower, i.e. roughly CZK 115.4 billion.

Chart 5 Local government investment in the Czech Republic 2016–2020



Source: Eurostat (2021); 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 level of debt of local and regional authorities is also very low and, as a whole, does not represent a significant risk factor in terms of growth in general government debt.

[16] Gross fixed capital formation in the local government subsector gradually increased from 1.3% of GDP in 2016 to 2.3% of GDP in 2020.

4.2 The budgetary responsibility rule for local and regional authorities and compliance therewith in 2020

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[17] at the balance-sheet date does not exceed 60% of its average annual revenues[18] 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").

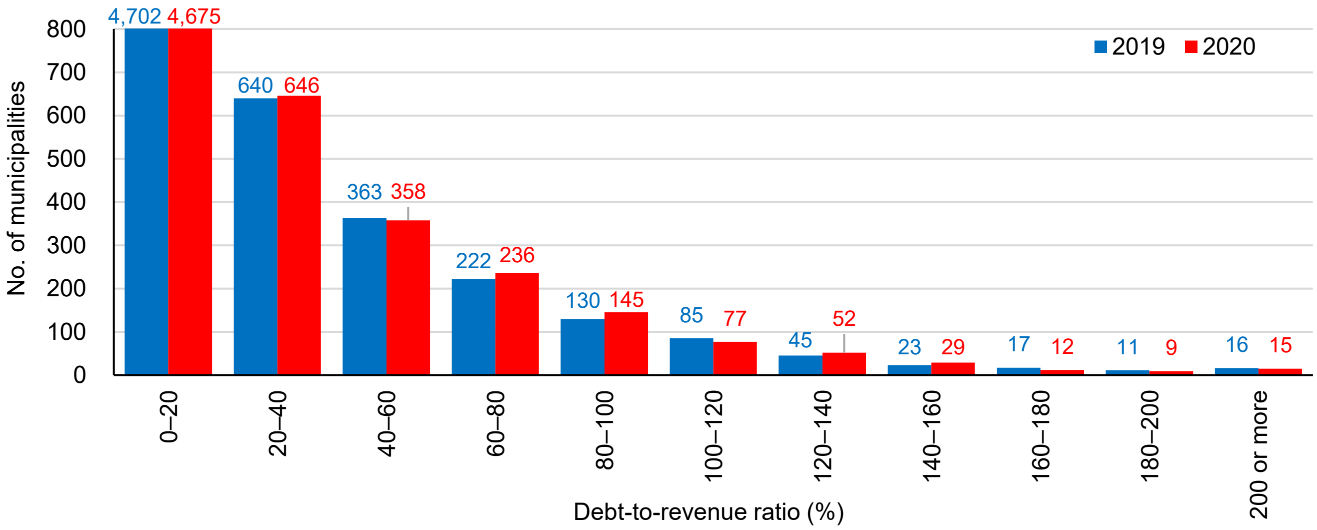
The Ministry of Finance monitors the finances of local and regional authorities on the basis of financial data and accounting records submitted by municipalities. In 2020, this monitoring covered 6,263 local and regional authorities of the Czech Republic, i.e. 6,250 municipalities,[19] including the City of Prague, and 13 regions.

Six of the total of 549 municipalities whose debt as at 31 December 2019 was higher than 60% of their average revenues over the previous four years were not compliant with the debt reduction rule. However, all of these municipalities took remedial action when called upon to do so by the Ministry of Finance, so the Ministry did not have to suspend the transfer of their shares in tax revenue.

Indebtedness in relation to the debt indicator

The budgetary responsibility rule indicator (i.e. the percentage ratio of debt to average revenues over the last four years) was above 60% as of 31 December 2020 for 575 of the total of 6,254 municipalities (i.e. for 9.2% of all municipalities). A total of 545,438 people, i.e. approximately 5.1% of the Czech population, live in these municipalities (in 2019, approximately 6% of the population were living in municipalities exceeding the indicator).[20] Figures are also available in Chart 6.

Chart 6 Numbers of municipalities in ranges according to the percentage level of the budgetary responsibility rule indicator, 2019 versus 2020



Source: MF CR (2020): Information on the Monitoring of Local and Regional Authorities' Finances for 2019, MF CR (2021): Information on the Monitoring of Local and Regional Authorities' Finances for 2020; CFC calculations.

[17] 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.
[18] 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.
[19] The municipalities of Šestajovice, Bratřejov, Bohuslavice and Jablůnka are excluded from monitoring due to failure to submit financial statements to the Central State Accounting Information System.
[20] Only 109,756 people live in municipalities where the budgetary responsibility rule indicator exceeds 100% (194, i.e. 3.1% of municipalities). This represents only 1.03% of the Czech population (in 2019 the figure was 135,325 people, i.e. 1.27% of the Czech population).

The total debt of municipalities in 2020 was CZK 65.3 billion, i.e. CZK 1.4 billion more than in 2019. The combined debt of municipalities exceeding the limit of 60% of average revenues was CZK 3.8 billion, i.e. the same as in 2019. The average debt of municipalities was 16.4% (16.1% in 2019). A total of 3,555 municipalities, i.e. 57% of the total, were entirely free of debt.[21] Fifty-five more municipalities had been debt-free in 2019.[22] The number of municipalities whose budgetary responsibility rule indicator exceeded 200% decreased from 16 to 15.

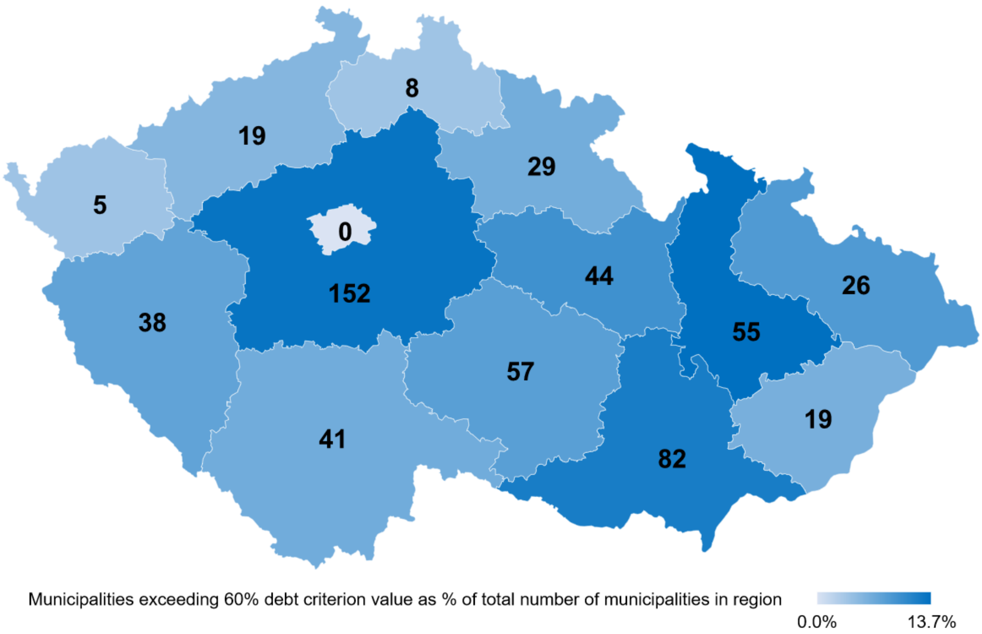
Table 4 Number of municipalities exceeding the 60% debt criterion value of the budget responsibility rule

No. of inhabitants of municipality	No. of municipalities		No. of municipalities exceeding 60% debt criterion value		% of municipalities exceeding 60% debt criterion value (%)	
	2019	2020	2019	2020	2019	2020
0–100	438	438	24	17	5.5	3.9
101–200	994	976	75	84	7.5	8.6
201–500	1,987	1,998	184	207	9.3	10.4
501–1,000	1,364	1,360	140	153	10.3	11.3
1,001–2,000	769	776	80	78	10.4	10.1
2,001 or more	702	706	46	36	6.6	5.1
Total	6,254	6,254	549	575	8.8	9.2

Source: MF CR (2020): Information on the Monitoring of Local and Regional Authorities' Finances for 2019, MF CR (2021): Information on the Monitoring of Local and Regional Authorities' Finances for 2020; CFC calculations.

Table 4 shows that in 2020, municipalities with 201–500 and 501–1,000 inhabitants most often exceeded the debt criterion value of the budget responsibility rule, whereas in 2019 it had been larger municipalities with 501–1,000 and 1,001–2,000 inhabitants.

Chart 7 Number of municipalities exceeding the 60% debt criterion value of the budget responsibility rule



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

[21] MF CR (2021): Information on the Monitoring of Local and Regional Authorities' Finances for 2020 (in Czech).
[22] MF CR (2020): Information on the Monitoring of Local and Regional Authorities' Finances for 2019 (in Czech).

Chart 7 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 (13.7% of municipalities). Central Bohemia and South Moravia also recorded more than 10% of municipalities exceeding the debt criterion of the budgetary responsibility rule (13.3% and 12.2% respectively). The best performers in this respect were municipalities in the Liberec and Karlovy Vary regions (3.7% and 3.8% respectively).

Besides the budgetary responsibility rule set by the Act, the Ministry of Finance monitors another two indicators in the case of municipalities. 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 share of assets covered by third-party finances, be no higher than 25% in the case of municipalities and regions. A total of 165 local and regional authorities (LRAs) – 155 municipalities (2.5% of all municipalities) and ten regions – exceeded this level in 2020, a year-on-year increase of 26 LRAs. In all, 111 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. 19.3% of the municipalities exceeding the debt criterion, or 1.8% of all municipalities. The municipalities exceeding both criteria are home to 0.6% of the population of the Czech Republic. The municipalities of Turovice and Prameny report the highest ratios of loans and advances to total assets (714.7% and 230.2% respectively).[23]

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 84 municipalities (i.e. 1.3%) are not compliant with this recommendation. This represents a year-on-year decrease of 20 municipalities.

In 2020, 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 seven municipalities (as against six in 2019). The total number of people living in these municipalities is 3,409, or 0.03% of the total Czech population (in 2019 the figure was 2,395). The limits on the monitored indicators were exceeded mainly due to the implementation of investment projects financed primarily from returnable resources (loans). The municipalities concerned often have only low immediately available financial reserves and their finances may therefore be exposed to the following risks:

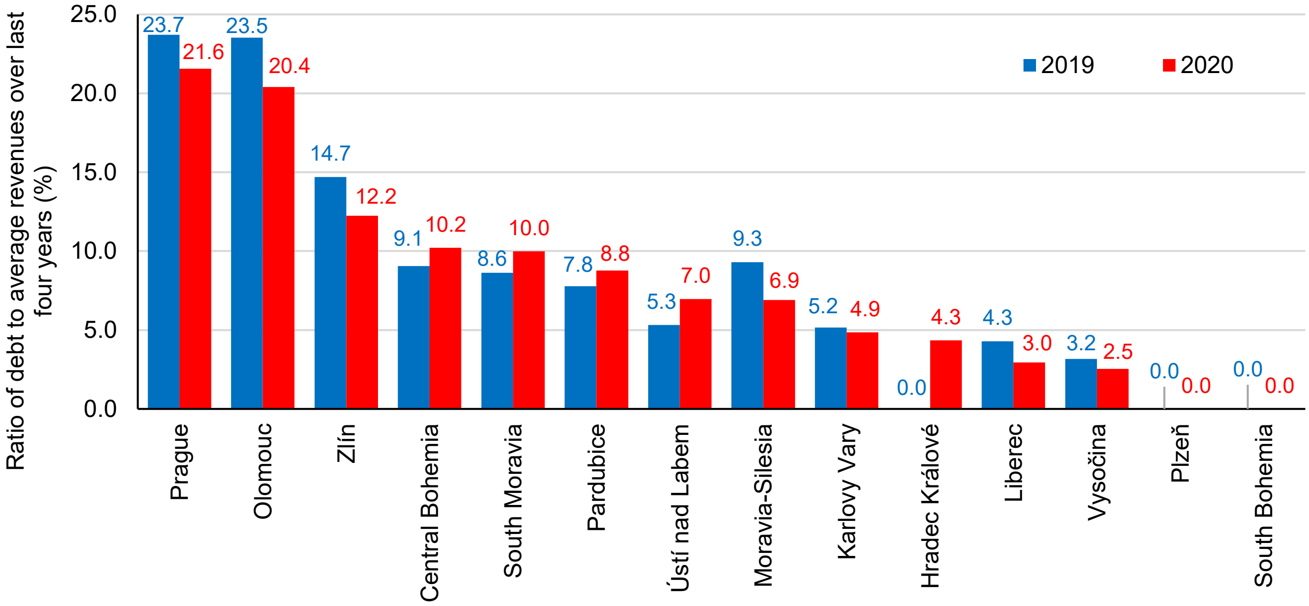
a) insufficient funds for the management and repair of tangible fixed assets,
b) the need to cover suddenly arising expenditures,
c) non-compliance with the conditions of subsidies provided/promised (including ensuring the sustainability of the project for the required period).

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.

At the level of regions, the debt criterion of the budgetary responsibility rule is fulfilled by a comfortable margin. The City of Prague[24] and the Olomouc region have reported the highest ratios of debt to average revenues over the last four years. By contrast, the regions of South Bohemia and Plzeň had absolutely no debt in 2020.[25] Compared to 2019, nine regions reported a drop in the ratio of debt to average revenues over the last four years. Increases were recorded by the regions of Hradec Králové (4.3 pp), Ústí nad Labem (1.7 pp), South Moravia (1.4 pp), Central Bohemia (1.1 pp) and Pardubice (1.0 pp). The figures are shown in Chart 8.

[23] A ratio of loans and advances to total assets in excess of 100% means that the municipality reports negative equity.
[24] 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).
[25] See MF CR (2021): Information on the Monitoring of Local and Regional Authorities' Finances for 2020 (in Czech).

Chart 8 Regions by debt-to-average revenue ratio over the last four years, 2019 versus 2020



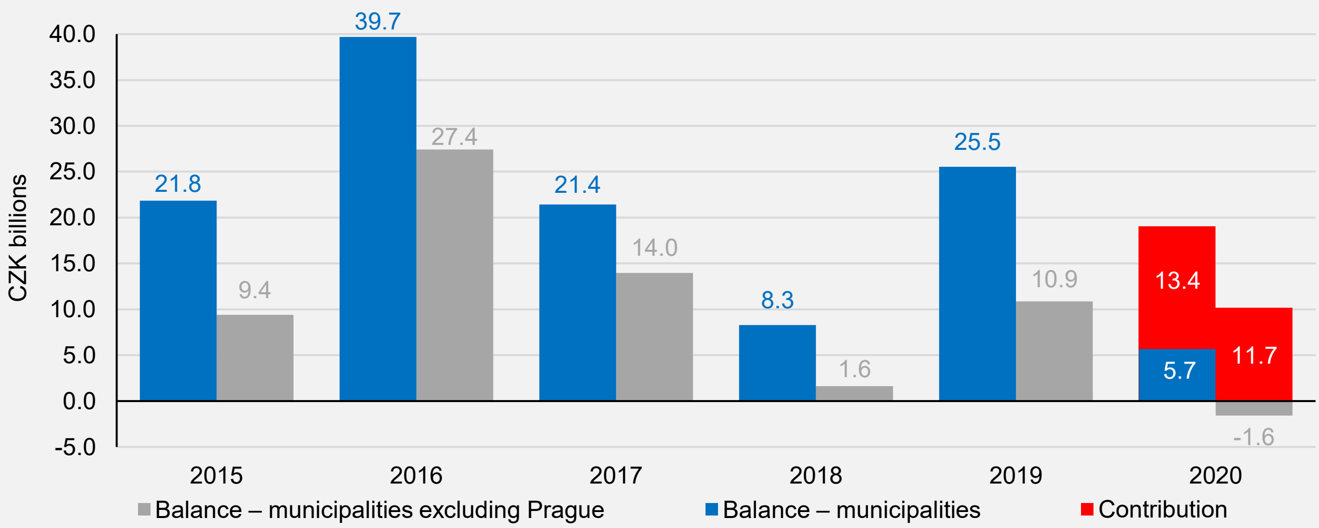
Source: MF CR (2020): Information on the Monitoring of Local and Regional Authorities' Finances for 2019, MF CR (2021): Information on the Monitoring of Local and Regional Authorities' Finances for 2020; CFC calculations.

Conclusion: As of 31 December 2020, a total of 575 municipalities and no regions exceeded the debt criterion defined in Section 17(1) of the Act. In 2020, a total of six municipalities were non-compliant with the obligation to reduce their debt by the minimum level defined in the Act. However, all of them took remedial action within the stipulated deadline, so there was no need to suspend the transfer of their shares in tax revenue.

Box 3 Effect of the one-off non-refundable contribution on municipal finances in 2020

An amendment to Act No. 159/2020 Coll., on the compensatory bonus in connection with crisis measures in connection with the occurrence of the SARS CoV-2 coronavirus, took effect on 7 August 2020. The amendment grants municipalities a one-off non-refundable contribution of CZK 1,250 per capita to compensate them for the drop in their tax revenues connected with payments of state assistance to the self-employed and partners in limited liability companies. The contribution amounted to just under CZK 13.4 billion overall. Without it, municipalities would have recorded a surplus of CZK 5.7 billion in 2020. This would have been the worst result in the period under review (see Chart B3.1). Excluding Prague, however, there would have been a deficit of CZK 1.6 billion.

Chart B3.1 Municipalities' financial results 2015–2020



Source: State Treasury (2021): Central State Accounting Information System; CFC calculations.

Table B3.1 shows the number of municipalities that recorded a deficit in 2020. While there were 1,770 such municipalities (i.e. 28.3% of all municipalities) at the year-end, the number would have increased to 2,293 (approximately 36.7% of all municipalities) had municipalities not received the contribution. The difference is largest for municipalities with more than 2,000 inhabitants; less than 30% of them recorded a deficit, but almost 42.9% would have done so without the contribution. However, the majority of municipalities of all sizes posted a surplus.

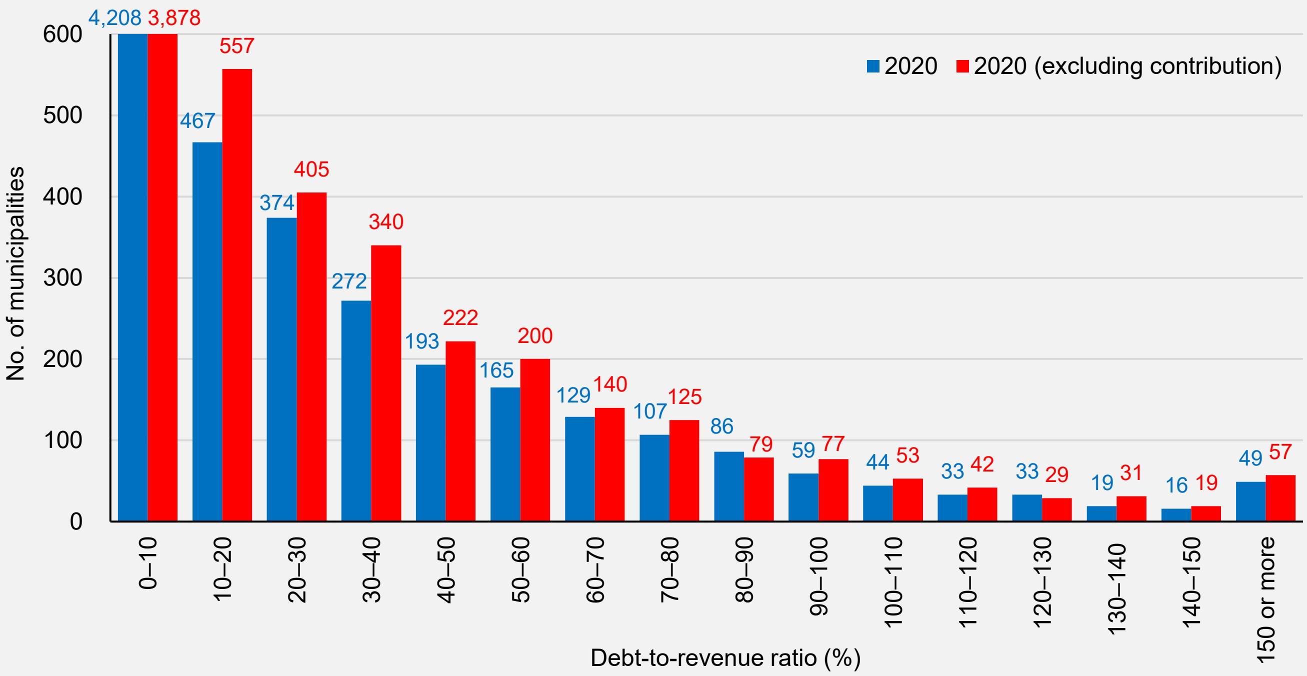
Table B3.1 Number of municipalities with deficits in 2020 by number of inhabitants

No. of inhabitants of municipality	No. of municipalities	No. of municipalities with deficit		% of municipalities with deficit		Average surplus of municipalities (CZK thousands)	
		including contribution	excluding contribution	including contribution	excluding contribution	including contribution	excluding contribution
0–100	438	91	116	21	26	413	322
101–200	976	249	317	25	32	410	222
201–500	1,998	544	691	27	35	716	301
501–1 000	1,360	426	552	31	41	1,091	200
1,001–2,000	776	251	314	33	40	1,817	60
2,001 or more	706	209	303	30	43	20,140	6,254
Total	6,254	1,770	2,293	28	37	3,044	906

Source: State Treasury (2021): Central State Accounting Information System; CFC calculations.

Chart B3.2 projects the debt of municipalities assuming that the contribution was not paid and that indebted municipalities would have used this income to reduce their debt.[26] In such case, municipalities' total debt would have exceeded CZK 78.6 billion and 652 municipalities would have broken the debt rule set out in the Act, i.e. 77 more than the number that actually breached it after receiving the contribution.

Chart B3.2: Effect of the one-off non-refundable contribution on the debt rule



Source: State Treasury (2021): Central State Accounting Information System; CFC calculations.

Conclusion: The CFC projection indicates that municipal budgets recorded a surplus in 2020 even without the contribution provided by the state under the amendment to Act No. 159/2020 Coll. However, the contribution increased the surplus of municipalities to CZK 19 billion and in particular reduced the expected increase in the debt of local and regional authorities.

[26] This assumption, however, is not entirely realistic, because municipalities will save part of the contribution.

Summary

The Czech Fiscal Council states that in 2020:

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) actual state budget and state funds expenditure exceeded the approved expenditure framework and the general government structural balance exceeded the limit (–0.75% of GDP) used in the procedure for deriving the state budget and state funds expenditure framework,
d) a total of 575 municipalities exceeded the 60% limit on local or regional authority debt (Section 17(a) of the Act),
e) a total of six municipalities were non-compliant with the obligation to reduce their debt in 2020 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 public budgets were strongly affected in 2020 by the economic impacts of the COVID-19 pandemic, which caused actual expenditure to diverge from the approved framework and the value of the structural balance to be exceeded. The relaxation of the fiscal rules under the double amendment of the Act meanwhile significantly increased the risk of collision with the debt rule in the relatively near future. It therefore seems necessary for the pace of fiscal consolidation in future years to exceed the planned 0.5% of GDP a year.