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OPINION

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on general government finances and fiscal and budgetary policy

Pursuant to the Section 21(2)(c) of Act No. 23/2017 Coll., on the Rules of Budgetary Responsibility, as amended, the Czech Fiscal Council (CFC) monitors general government finances. As part of this activity, it also seeks to identify risks that may negatively affect the stability of public budgets in the short, medium, and long term. Since September 2018, the CFC has been informing the public of its conclusions on a quarterly basis.

Initial economic situation

The third quarter was statistically the worst in terms of the Czech economy's performance this year. For the first time, real gross value added (GVA) fell in both quarter-on-quarter and year-on-year terms. GVA fell by 0.4 % (q/q) and by 0.1 % (y/y). The main contributor to the q/q decline was the fall in value added in manufacturing (-0,7 %). While industrial production grew year-on-year in the first two quarters, it contracted by 3.3 % (y/y) in Q3 and fell by 2.1 % (q/q). Moreover, the November surveys showed that confidence of industrial producers in the economy declined slightly compared with October. The trade, transport and hospitality sector also recorded a significant q/q decline in value added (-0.6 %), as illustrated by services sales, which recorded a quarter-on-quarter decline of 1,2 %. Services sales declined for the third consecutive quarter, with the transport a storage sector contributing the most.

GDP fell by 0.5 % quarter-on-quarter and by 0.7 % year-on-year. The y/y decline was due to lower household consumption and a reduction in inventories, while external demand, government consumption and gross fixed capital formation were positive. The consequence of q/q decline in household consumption (-0.3 %) is the month-on-month decline in retail sales in both August and September (-0.8 % and -0.4 % respectively). Although foreign trade contributed positively to the year-on-year GDP growth, it was exports of goods and services that declined on quarter-on-quarter basis for the first time (-1.2 %). Government consumption rose (+1.2 % q/q) and is thus the only component of GDP expenditure items that grew in all quarters this year. Gross fixed capital formation recorded a decline (-0.3 % q/q) after strong q/q growth in Q2.

After September's annual inflation of 6.9 %, the October annual inflation rate was 8.5 %. However, the increase in inflation was due to so-called “economical tariff' (government contributions which reduced electricity prices last year). If the “economical tariff” had not been included in the calculation, the annual inflation rate would have been 5.8 % in October 2023 and inflation would have fallen again. Moreover, in October, prices of agricultural producers fell by almost 10 % (y/y) and prices of industrial producers rose only by 0.2 % (y/y).

General government finances and fiscal policy settings for the coming years

After improving over the summer, the government budget deficit started to widen again in October and November. This is, among other things, a consequence of the fact that significant corporate income tax and windfall profits tax revenues, which are paid at quarterly intervals, were not collected in these months. At the end of November, the state budget deficit reached CZK 269.1 billion, but after adjusting for revenues and expenditures related to EU projects, the deficit was almost CZK 30 billion higher (CZK

296.8 billion). This is higher than the approved full-year balance (CZK -295 billion), which assumes an even balance of revenue and expenditure related to EU projects.[1]

In terms of overall trends, it appears that the balance of one-off revenues and expenditure related to the energy market interventions is likely to be negative with a high degree of probability, as revenues from the windfall profits tax and the levy on electricity producers will not reach the total expenditure related to energy price caps and subsidies to the transmission system and distributors. Conversely, the impact of revenue shortfalls due to the inability to include the Modernization Fund for current expenditure (CZK 50 billion) and the costs of extraordinary pension indexation (about CZK 15.5 billion) will be largely offset by higher than planned collections of both income taxes and a higher than originally planned CEZ dividend.

In the last month of this year, the deficit can be expected to continue widening, as capital expenditure is generally spent in planned amount. On the other hand, the quarterly payment of corporate income tax and windfall profits tax should contribute positively.

However, the key to assessing fiscal (im)balance is the performance of general government, i.e., in addition to the state budget and state funds, also balance of local governments and health insurance companies should be considered. Municipalities and regions reported a surplus (in cash terms) of over CZK 77 billion at the end of September, which was about CZK 17 billion more year-on-year and about CZK 16 billion more than at the end of June this year. Local governments are thus contributing to the improvement in the general government balance. In contrast, the health insurance system posted a slight deficit in cash terms at the end of October of CZK 4 billion. The general government is expected to be running a deficit close to 3.6% of GDP at the end of this year, with a structural deficit of around 2.3% to 2.5%, which is more or less in line with the current forecast of the Ministry of Finance.

In this context, the CFC reiterates its position on the state budget law for 2024, which has already been approved today. The budget implies a public budget deficit of 2.2% of GDP next year, which the CFC considers a reasonable and credible estimate given the current state of information and forecasts of future developments. However, the overall economy may still be burdened by additional spending in the health, education, and energy market intervention sectors, which are currently under discussion. However, if the above-mentioned balance can be maintained, it will be a visible improvement compared to this year and also to 2022, in which the public budgets recorded a deficit of 3.2% of GDP thanks to unexpectedly good corporate tax collection. The structural deficit of general government is expected to improve towards 2% of GDP in 2024. The CFC notes that despite this improvement, which can be attributed to the government's consolidation measures for 2024 and 2025, a strong structural imbalance remains built into the system, which will require further measures on both the revenue and expenditure side after 2025. In this context, the CFC welcomes the fact that a trajectory back to a safe level of structural balance has been built into the amendment to the Act No. 23/2017 Coll., on the Rules of Budgetary Responsibility, which is the trajectory set for any government emerging from the 2025 parliamentary elections.

The CFC also appreciates the government's commitment to making changes to the pension system. The proposals were submitted by the Ministry of Labour and Social Affairs for comments in November. They contain relatively significant changes to the current system, in particular linking the retirement age to life expectancy, adjusting the calculation of new pensions and other partial changes aimed at reducing the differences between men's and women's pensions (common assessment base, notional assessment base, etc.). The CFC considers that the adjustment of the retirement age and the method of calculating new pensions (in combination with the already adopted adjustment of the indexation formula and the conditions for early retirement pensions) are absolutely necessary to prevent public finances from being put on an unsustainable trajectory since the second half of the 1930s.

[1] The issue of interpretation of key fiscal indicators are discussed in Musil and Bárta (2023): Guide to the World of Public Deficits