Národní rozpočtová rada

Office of the Czech Fiscal Council

CZECH FISCAL COUNCIL

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OPINION

of the Czech Fiscal Council

Number 5/2023

of 7th September 2023

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 publishing its conclusions on a quarterly basis.

Initial economic situation

Gross domestic product (GDP) fell by 0.4% year-on-year in the second quarter of 2023 and rose by 0.1% quarter-on-quarter, virtually identical to the first quarter. However, this year is unique due to the interventions in the energy market, which affect the balance of taxes and subsidies, and a split can be observed between the development of gross value added (GVA) and GDP. GVA grew by 0.6% year-on-year in the second quarter and fell by 0.2% quarter-on-quarter, so its dynamics mark a more positive evolution of the domestic economy compared to GDP.

The main factors behind the quarter-on-quarter GDP growth were gross fixed capital formation (3.4% q-o-q), external demand, with the trade balance achieving a surplus of CZK 79.8 billion in the first half of the year compared with a deficit of CZK 83.2 billion in the same period last year, and household final consumption expenditure (0.2% q-o-q) which rose for the first time in six quarters. The recovery in consumer demand in the second quarter is also reflected in retail sales, which rose in real terms by 0.3% and 0.5% month-on-month in May and June.

Although the manufacturing industry contributed the most to annual GVA growth in the second quarter, rising by 3.8%, the July figures were already negative. Most of the manufacturing sector posted a noticeable month-on-month and year-on-year decline in July. Industrial production fell by 2.6% month-on-month on a seasonally adjusted basis and the value of new orders fell by 3% year-on-year in nominal terms in July.

Consumer prices were 8.8% higher year-on-year in July, and inflation thus continued to fall in annual terms. However, month-on-month, consumer prices rose by 0.5%, with prices of goods falling by 0.3% (mainly due to food) and prices of services rising by 1.6%. This development was mainly due to higher prices in the recreation and culture section, which is typical for July. The trend in the unemployment rate since the beginning of the year does not suggest any significant changes.

General government finances and fiscal policy settings for the coming years

As in previous months, the Czech public finances continue to run an overall deficit, driven by imbalances in the part directly accountable to the government (the state budget and state funds). While municipalities and regions maintain a surplus (at the end of June, the surplus was CZK 61.3 billion in cash terms) and the balance of health insurance funds oscillates around zero (at the end of July the surplus was CZK 1 billion in cash terms), the state budget posted a deficit of CZK 194.6 billion at the end of September.[1] However, it is the result adjusted for revenues and expenditure related to EU projects that is relevant for the assessment of its situation, which was more unfavourable and amounted to CZK -230.8 billion. Since June, however, there has been a month-on-month reduction in the negative balance of the state budget, which was predominantly due to higher-than-expected corporate income tax payments for 2022 in June and July and the payment of an unusually high dividend from CEZ in August.[2] A one-off positive injection on the income side can also be expected in September, when three-quarters of the advance tax payments on windfall profits will be due.

In terms of expenditure and revenue dynamics, except for the corporate income tax, there is no significant change compared to previous months. Personal income tax collections are slightly better than budgeted, while indirect tax receipts are lagging, reflecting a decline in household consumption.

The overall balance of the state budget at the end of the year, or its possible deviation from the approved balance, will depend mainly on the balance of revenue and expenditure related to the situation on the energy market (levies on excessive revenues and windfall profits tax vs. compensation for capping energy prices and subsidies to the transmission system operator), which will very likely be negative. The balance will not become clearer until around October or November. The absence of the planned revenues from the Modernisation Fund (CZK 50 billion), which cannot be compensated for by the already mentioned higher-than-expected corporate income tax revenues (approx. CZK 40 billion), is also contributing to the higher-than-expected deficit. The third negative factor is the cost of the extraordinary indexation of pension insurance benefits (from June), which was not included in the draft budget (approx. CZK 14 billion). Thus, as in the past, the CFC states that without further interventions on expenditure, it cannot be expected that the approved balance of the state budget (net of the impact of revenues and expenditures related to EU projects) of CZK -295 billion could be maintained. Moreover, as the CFC has argued before, this deficit does not consider the deficit financing of the State Fund for Transport Infrastructure, which has a direct negative impact on the public budget balance.

In terms of the development of the public sector in the coming years, the CFC expects a continuation of the surplus management of municipalities and regions and a roughly balanced management of health insurance companies. The overall balance of the public sector will thus again be dominated by the shape of the state budget, the first version of which was presented by the Ministry of Finance (MoF) at the end of August. It works with a deficit of CZK 252 billion. If approved in this form, a structural deficit of the entire public finances of around 2.1% of GDP could be expected, which would mean an improvement of around 0.2% of GDP compared to the previous year.[3] This is less than announced in the documentation of the consolidation package.[4] In the following years, the MoF assumes that the structural imbalance will be maintained at around 2% of GDP, which the CFC does not consider sufficient in the medium term and recommends continuing consolidation of public finances after the implementation of all revenue and expenditure measures from this package, i.e. after 2025. Only further consolidation will ensure the return to long-term sustainable public finances as defined by the Law on the Rules of Budgetary Responsibility. [5]

However, the above draft budget is burdened by a relatively high degree of uncertainty, as some adjustments on both revenue and expenditure are still pending.[6] While some partial adjustments to the

[1] The state of affairs of municipalities and regions and health insurance companies is published with a longer time lag than in the case of the state budget.
[2] Higher-than-expected corporate tax collections for 2022 are likely to improve the overall general government balance for last year from -3.6% of GDP to -3.2% of GDP.
[3] Draft medium-term outlook of the state budget for 2025 and 2026, p. 8.
[4] The Final Report of the Regulatory Impact Assessment sets a fiscal effort target of 1.2% of GDP in 2024 and 2025.
[5] One of the proposals included in the consolidation package is a modification of the law on the rules of budgetary responsibility. This should set the trajectory for the Czech Republic's return to the so-called medium-term budgetary objective, which was not applied during the Covid-19 pandemic.
[6] In particular, the inclusion of unapproved revenues in the state budget is not in line with the general principles of budgeting and entails significant risks, an example of which could be the non-fulfilment of the budgeted revenues from the Modernisation Fund this year.

pension system have already been legislated, the so-called consolidation package is still in the legislative process.

The CFC sees the draft state budget for 2024 as crucial, as it is the first budget after the consolidation package and the last one before the 2025 election year. Furthermore, the CFC points out that if the state budget deficit or state extra-budgetary funds were to be further increased, the announced positive effect of the entire package would be completely nullified.

On the contrary, budgeting in the following years will be simplified by the fact that the Czech Republic will not eventually draw down on the loan from the National Recovery Plan in the amount originally considered, and its drawdown will therefore not affect the expenditure frameworks and the deficit in the originally calculated amount.

The CFC welcomes the government's efforts to adjust the pension system towards greater financial sustainability. Both the partial adjustments to the system of regular indexation, the tightening of conditions for early retirement pensions and the consideration of linking the retirement age to life expectancy are moving in the right direction and have the potential to put the current system on an appropriate trajectory. However, the CFC continues to point out that, in addition to the first, pay-as-you-go system, the functioning of Pillar III where public money spent is not having the desired effect of strengthening the financial situation of pensioner households needs to be significantly adjusted. Many of the government's proposed changes to Pillar III are in the right direction, yet, they are not sufficient and have not yet been finally approved.