Office of the Czech Fiscal Council

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Concerning the development of public sector finances and the set-up of fiscal and budgetary policy

Pursuant to Section 21(2) (a) of Act No. 23/2017 Coll., on budgetary responsibility rules, as amended, the Czech Fiscal Council monitors the development of public sector finance. Within the framework of that work, it also strives to identify risks and threats that may have an adverse impact on public budget stability in the short-, medium-, and long-term. Since September 2018, the Czech Fiscal Council regularly, on a quarterly basis, has informed the public about its conclusions.

Basic economic situation

The Czech economy noted 3.7% year-on-year growth in Q2 of this year. The main growth factor was gross capital formation, which was up by 12.6% year on year; however, the contribution of investment demand was far lower, as gross fixed capital formation itself was up by only 6.2%. The majority of the strong growth of gross capital formation was thus driven by an increase in inventories. Final consumption expenditure also made a positive contribution, mainly final consumption expenditures of general government, which were up by 1.8%.

By contrast, the balance of foreign trade in goods and services ended in deficit for the fourth consecutive quarter, this time at CZK 25.8 bn. Export growth increased by 1.8% year on year, mainly due to growth in export of services. Imports generated a yet stronger increase, of 2.7%, primarily thanks to the growing imports of oil and natural gas. The slowing growth of foreign demand and the persisting shortage of parts and materials, magnified by the war, may be further manifest in weak export dynamics and in continued formation of inventories.

The trade, accommodation, and food service industries played the main part in the year-on-year growth in gross value added, of 3.4%, having contributed 1.4 p.p. After two quarters of decline, industry generated a positive contribution of 0.2 p.p. More than one-half of companies in industry and the construction business expect a further growth in sales prices in the coming 3 months. Inflation in the manufacturing sector is being driven primarily by further increases in gas and electricity prices. Positive news, on the other hand, is that 70% of businesses in the service sector expect price stability in the coming months.

In July, the year-on-year growth in consumer prices reached 17.5%. Housing and food prices had the greatest impact on the year-on-year growth of the price level, followed by an increase in prices in the transport sector and food services. Year-on-year core inflation in the Czech Republic in July, as measured by the Eurostat methodology, at 13.4%, was the highest in the entire EU. In a month-to-month comparison, however, inflation dropped for the second time in a row, from May growth of 1.8% to July growth of 1.3%.

Tensions on the labour market persist. According to a Selected Workforce Survey (Czech Statistical Office), employment grew by 123,200 persons in Q2. The total number of unemployed dropped by 28,700 persons, and the unemployment rate was down by 0.6 p.p. year on year, to 2.4%. The same trend can be seen in the Ministry of Labour and Social Affairs (MLSA) statistics, where the share of unemployed persons was down by 0.4 p.p year on year, to 3.3%. As concerns wage development in Q2, there was nominal growth in the average gross monthly wage, by 4.4%, but due to the high inflation, the average wage noted a drop in real terms, of 9.8%.

There is a high degree of uncertainty about future developments. Uncertainty about prices and energy supply is adding to the concerns about the persistently high inflation rate and tightening monetary policy, which not only stifles economic activity, but also has a significant impact, for example, on interest payments on government debt.

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

The performance of the most important component of the public budget system – the state budget – closed August with a deficit of CZK 231.1 bn; net of EU-related revenues and expenditures, the deficit was CZK 13 bn lower. For the time being, the deficit is in line with the aggregate deficit proposed in the currently discussed state budget amendment bill (CZK 330 bn.). Both the revenue and the expenditure sides are growing rather dynamically. On the revenue side, the main driver is VAT, with an 18.5% year-on-year increase in revenue. This is a logical consequence of the dynamic growth in the price level. Also, revenues from selective excise duties (9.9%), social security contributions (6.3%), and, above all, corporate income tax (15.5%) maintain relatively solid year-on-year increases. In the case of selective excise duties and VAT, there is a risk of a potential slow-down in household consumption expenditure in the future, in connection with the drop in real income. The expenditure side has been and will be burdened significantly by extraordinary indexation of pension insurance benefits (CZK 28 bn) and a one-off child benefit of CZK 5,000 (CZK 7.8 bn).

At the end of August, the Ministry of Finance submitted a draft of the 2023 state budget to the government, planning on a deficit of CZK 270 bn. This is major visible shift compared to the current year, when a deficit of CZK 330 bn is envisaged. Unfortunately, upon closer inspection, there can be no illusion as to a significant improvement in the situation. It must also be stressed that the draft does not feature all of the expected expenditures (an energy-saving tariff, growth in wages of government employees), posing a major risk of a further deficit increase. The document presented also shows that the aggregate public sector deficit will remain nearly unchanged, compared to the expected outcome of this year, and will stagnate at around 3.8% of GDP. Also, the improvement in the key structural balance indicator will be rather cosmetic, as the prediction of the Czech Ministry of Finance shows (from -3.1% of GDP to -3.0% of GDP). What is, however, alarming is the fact that the outlook for 2024 and 2025 does not present a significant reduction in the imbalance of public finances, as it conserves the structural deficit at 2.9% of GDP.

It is evident from the above that the government does not plan to adopt major changes that would restore public finance to a sustainable level. A structural balance of around -3% of GDP will also mean that the Maastricht convergence criterion, i.e., that the total deficit would not exceed 3% of GDP, will not be adhered to in the event of any one-off expenditures or a negative output gap. Again, no attempt is being made to create room for a fiscal policy response to a future crisis, for which the CFC criticised the previous government, as well.

The CFC believes that, despite the difficult international situation, public budget consolidation should be a priority for the government. It is clear that the energy crisis and the related aspects will require intervention from public budgets; nevertheless, it is necessary for these measures to be one-off and temporary, such that they not result in a further deepening of the structural deficit. Furthermore, the CFC believes that, for these one-off measures, one-off revenue should be sought to the greatest extent possible, in order to reduce the dynamism of the swelling of government debt. In this regard, a windfall tax could be mentioned, which is already under discussion and which the CFC considers to be a suitable solution in the present economic situation, as, when set up appropriately, it does not have a significant dampening effect on economic performance.

The CFC again points out that, at present, the recovery of public finance cannot be achieved through simple and painless measures. It must either be admitted that, with the present level of public expenditures, public budgets do not have adequate revenue capacity, and hence, taxes must be increased, or an adjustment must be made on the expense side, in mandatory and quasi-mandatory expenditures; however, that can be achieved only by a change in the relevant laws, either those that define the scope of social benefits or those that define the activities to be performed by the government sector. Due to time constraints, this is nearly impossible to do in the 2023 budget. Only if agendas are reduced will it be possible to reduce the government sector headcounts and achieve savings that are sustainable in the long-term; however, this route requires a certain amount of time and must be taken as soon as possible. On the other hand, the CFC believes that the structural deficit should not be reduced by a reduction in investment activity, as the Czech Republic continues to report a major infrastructure gap that needs to be closed.

Public budget recovery also seems very important in the context of strong inflationary pressures in the economy. It is evident that the massive loosening of fiscal policy in 2020 and, in particular, in 2021, strongly contributed to the demand component of inflation and fiscal restrictions thus help slow it down.

In light of the above, the CFC believes that, aside from addressing current problems related to the energy crisis, work should be commenced not only on a thorough review of agendas, and also proposals should be drawn up to strengthen the revenue side of public budgets. The theses repeatedly declared by the CFC still apply – that the consolidation of Czech public finance will require an increase in the tax burden, as the longer-term shortfall in revenues, in the scope of the autumn 2020 tax package (doing away with super-gross wage taxation and increased taxpayer credit) cannot be fully offset by a reduction in expenditure (short of a major reduction in expenditures in the largest blocks of expenditures – social security, healthcare, and education).

As in the case of medium-term sustainability, there has unfortunately been no improvement in long-term sustainability. This includes, in particular, the pension system, which will start to drop into significant deficits in the 2030s. Thus far, no measures addressing the imbalance have been specified. The changes in the pension system discussed by the Pension Reform Advisory Team are only partial in nature, many of which reduce the sustainability of the system (either reducing revenues or increasing expenditure). In the CFC's view, inadequate attention is being paid to the reform of the 3rd pillar, which is, despite significant direct and indirect support from public budgets, not fulfilling its main task of strengthening the regular income of pensioners' households.