**Office of the Czech Fiscal Council**

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*on general government finances and fiscal and budgetary policy*

Pursuant to Section 21(2)(a) of Act No. 23/2017 Coll., on the Rules of Budgetary Responsibility, as amended, the Czech Fiscal Council monitors general government finances. As part 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. The Czech Fiscal Council has informed the public about its conclusions every quarter since September 2018.

**Initial economic situation**

According to the CZSO’s revised estimate, the Czech economy grew by 1.7% year on year in Q3. This result was driven mainly by foreign trade, where real export growth of more than 10% occurred. Gross fixed capital formation also contributed positively to the growth, mostly via investment in buildings and transport equipment. Final consumption expenditure conversely made a negative contribution, falling by 4.4% year on year. Household consumption was the biggest contributor to this decrease, dropping by 5.9%, one of the worst results in modern history. It is being affected by declining real incomes and worsening sentiment. These factors were also reflected in a quarter-on-quarter contraction of the economy of 0.2%. Gross value added recorded the same result, influenced mainly by the wholesale and retail, transport, hospitality and construction sectors.

Business confidence in the economy also declined in November for the sixth time in a row. In terms of sectors, the decline was driven most of all by industry, while wholesale and retail and services tended to stagnate. The consumer confidence indicator improved but remains very low. There is great concern about rising unemployment, whereas concerns about expected inflation in the next twelve months are at their lowest levels since the end of 2020.

Year-on-year growth in the consumer price index stood at 15.1% in October, almost 3 pp lower than in September. In month-on-month terms, there was a decrease of 1.4%. However, government measures – in the form of a time-limited waiver of the levy on renewable energy sources and an energy savings tariff” – had the biggest impact on inflation in October. Without these measures, the index would have recorded year-on-year growth of 18.6%. At 14%, core inflation, as measured by the Eurostat methodology, remains the equal highest in the EU together with Hungary.[[1]](#footnote-1)

According to the Ministry of Labour and Social Affairs, the share of unemployed persons was flat at 3.5% in October. The labour market remained tight in Q3 according to the Labour Force Survey. Total employment went up by 1.1 pp year on year to 75.9%. In the sectoral classification, the tertiary sector in particular saw an increase in total employment. The unemployment rate fell by 0.5 pp year on year to 2.3%. The average wage increased by 6.1% year on year, but real wages dropped by 9.8% as a result of the high inflation.

A further decline in economic activity is expected at the turn of the year. The aforementioned decrease in household consumption resulting from the fall in real income, along with worsening sentiment and weakening external demand, will contribute to this cooling.

**General government finances and fiscal policy for the coming years**

The economic situation – characterised by slowing year-on-year economic growth and a high inflation rate – is fundamentally affecting public budgets and, coupled a significant structural imbalance, is pushing them into wide deficits. This imbalance is concentrated in the most important component of the public budget system – the state budget, which showed a deficit of CZK 337.1 billion at the end of November (adjusted for revenue and expenditure relating to the financing of projects supported by EU funds, the deficit was somewhat more favourable at CZK 302.5 billion). An amendment to this year’s budget also came into force in November, widening the planned deficit to CZK 375 billion.

This year, the expenditure side of the state budget is additionally burdened by a double extraordinary indexation of pensions and spending related to high energy prices (the “energy savings tariff”). On the revenue side, the higher inflation is generating growth in VAT revenue, but the fall in the real consumption expenditure of households carries a possible risk of non-fulfilment of the assumptions about the level of VAT revenue.

Other parts of the public budget system are significantly less affected. Local and regional authorities (municipalities and regions) continue to generate relatively significant surpluses. The local and regional authorities surplus adjusted for the direct costs of education and subsidies for private schools reached CZK 47.6 billion at the end of September.[[2]](#footnote-2) The surplus was reflected in a further increase in local and regional authorities’ current and term account deposits, which amounted to CZK 351 billion, representing 57.6% of the total budgeted expenditure of local and regional authorities for this year.

In November, the Chamber of Deputies approved the State Budget Act for 2023, which counts on a deficit of CZK 295 billion. However, the total planned imbalance is higher, as the subsidy from the state budget to the State Fund for Transport Infrastructure (SFTI) does not cover all the STFI’s planned expenditure. The SFTI is thus expected to run a deficit of CZK 30.7 billion in 2023.[[3]](#footnote-3)

The approved budget is also subject to a high degree of uncertainty. Expenditure on extraordinary pension indexation in 2023 constitutes an upside risk to the deficit. Based on the expected inflation path, it can be estimated that the 5% threshold for consumer price inflation (on the relevant date for determining the size of the regular indexation) will be exceeded in January 2023, meaning that extraordinary indexation of pension insurance benefits will be triggered in June. This will require additional expenditure of around EUR 20 billion that is not foreseen in the current budget. Given the large amount, it cannot reasonably be assumed that this spending can be covered by making savings in other items of the state budget.

Another risk on the expenditure side is compensation arising from the regulation of energy prices for households and SMEs. Its specific amount will depend on energy prices in 2023 and on the concrete form of the compensation mechanism. On the revenue side, the expected income of approximately CZK 100 billion from levies on electricity producers and the windfall tax can only be considered an educated estimate. The actual figure may be significantly influenced by the economic behaviour of individual taxpayers and again by the price of electricity in 2023.

From the point of view of medium-term public finance sustainability, it seems necessary to present a consolidation strategy for 2024 and 2025 based on specific legislative proposals governing both the revenue and expenditure sides of the budget. The medium-term outlook presented so far assumes that the structural deficit will be preserved at around 3% of GDP, which the CFC does not consider to be a sustainable level. In recent weeks, however, a discussion has been underway at the government level on measures to improve this balance, and their specific form should be known in the first half of 2023. The CFC welcomes the fact that this debate has been opened and that measures are being discussed not only on the expenditure side, but also on the revenue side. The CFC’s position remains that if the three main expenditure blocks – pensions, health care and education – are not adjusted, the current structural imbalance cannot be reduced solely by cutting expenditure, and that it will therefore be necessary to increase public budget revenues.

From the perspective of long-term public finance sustainability, the CFC’s recommendation to work on adjusting the current pension system so that it is better able to face demographic change, which will start to have a very significant impact on public finances in the 2030s, continues to apply. The CFC welcomes the fact that the first model-based calculations of possible parametric adjustments to the pay-as-you-go system leading to a reduction in future financial imbalances have been presented in the Advisory Team to the Minister of Labour and Social Affairs. At the same time, however, the CFC believes that a significant modification of the “third pillar”, which to a large extent is not fit for purpose in its current form, should be an integral part of the reform steps. The main problems at present include a very low rate of return on deposited funds and the fact that most people withdraw their savings as a lump sum and do not use them for regular monthly payments at retirement age. At the same time, the fees in the third pillar are higher than would be consistent with their conservative strategy and profitability. Unfortunately, no significant adjustments to this pillar have been introduced to eliminate the above-mentioned fundamental defects. The changes to the third pillar proposed so far – the “investment pension account” – would tend to exacerbate its existing problems.

1. In the case of inflation, attention should be drawn to the threat of inflation expectations becoming unanchored and the related risk of a wage-price spiral emerging, which would mean the inflation rate remaining elevated for longer than previously assumed. [↑](#footnote-ref-1)
2. MF CR (2022): *Zpráva o vývoji rozpočtového hospodaření obcí, dobrovolných svazků obcí a krajů k 30. 9. 2022* [*Report on the Budgets of Municipalities, Voluntary Unions of Municipalities and Regions as of 30 September 2022*, in Czech only] https://www.mfcr.cz/cs/verejny-sektor/uzemni-rozpocty/hospodareni-obci/mesicni-zpravy-o-hospodareni-uzemnich-ro/2022/zprava-o-vyvoji-rozpoctoveho-hospodareni-49412 [↑](#footnote-ref-2)
3. For more details on this issue, see CFC (2022): *Vyjádření Národní rozpočtové rady k návrhu státního rozpočtu na rok 2023* [*Statement of the Czech Fiscal Council on the Draft State Budget for 2023*, in Czech only], https://unrr.cz/vyjadreni-nrr-k-navrhu-statniho-rozpoctu-na-rok-2023/ [↑](#footnote-ref-3)