Office of the Czech Fiscal Council

CZECH FISCAL COUNCIL

OPINION

of the Czech Fiscal Council

Number 1/2021

of 4 March 2021

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

Pursuant to Act No. 23/2017 Coll., on budgetary responsibility rules, Section 21(2)(a), 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-term, medium-term, and long-term. Since September 2018, the Czech Fiscal Council regularly, on a quarterly basis, has informed the public about its conclusions.

Macroeconomic background

Second reading of GDP released by Czech Statistical Office (CZSO), on 2 March 2021, has confirmed the full-year 2020 GDP decline by 5.6%. The greatest drop was noted in investment demand, which was down by 8.5%, compared to 2019, and contributed by more than half to the overall economic decline. In Q4 alone, investments fell by 12.3%. On the other hand, exports revived, having noted an increase by 4.7%; exports of goods alone were up by 8.9%. Household consumption in the last quarter dropped by 8.3%, despite the pre-Christmas opening of shops. This was a drop of an extent similar to that which had occurred in the second quarter, when shopping opportunities were yet more limited. Government consumption was up by 4.9% at the end of the year, mitigating the overall weakening of consumption in the economy to 4.3%.

Industry confirmed a recovery at the end of the year, when, after a strong quarterly rise by 18% in the third quarter, gross value added in industry registered a mild quarter-on-quarter growth of 2.3% in the fourth quarter. The connection to the recovery in exports is evident; industry and exports are the economy's main stabilising elements.

Even though the beginning of 2021 brought a worsening of the pandemic, including a tightening of related measures, February's expectations of industrial enterpreneurs were unexpectedly favourable. More than one-fifth of them expect an increase in production activity, while on the other hand, only one-tenth of industrial companies are afraid of a reduction in foreign demand and approximately the same number are considering layoffs.

The service sector is in a far worse situation than industry – in the last quarter, the average value added in the segment declined in the vast majority of service industries. Leaving aside the slight increase in services paid predominantly from public sources (public administration, education, and healthcare), only services linked to information and communication technologies have withstood the pressure of the pandemic, with value added growing by 1.5% year on year. On the other hand, trade, transport, and warehousing sustained a drop by nearly 15%. In connection with the pandemic, a closure of most services continued in the Q1 2021, with very unclear prospects for Q2.

Consumers have responded to the situation. According to February CZSO surveys, they increasingly expect a deterioration of the economic situation and are afraid of rising unemployment and inflation. The year-on-year growth in consumer prices registered a slowdown below 3% in the last quarter of 2020; nevertheless, January CPI still reached 2.2%. Inflation has thus been moving above the inflation target of the central bank for the fifth consecutive year, with short-term exceptions. Development on the labour market does not correspond to the depth of the economic deterioration, not even if adjusted for the usual lag of several months. According to the MSLA, the number of available jobseekers aged 15-64 years amounted to 291,000 at the end of January 2021, which was 81,000 more year on year. The unemployment rate grew to 4.3% from 3.1% the year before.

What is especially striking is the development in the number of vacancies – as at the end of January 2021 (325,000), which was only 16,000 less than the year before, and still higher than the number of job-seekers available. An explanation may consist in the significant drop in the number of foreign employees that saturate the Czech labour market in a regular situation, and potentially also imprecise data of the MLSA that comes from Labour Offices.

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

The development of public finance in the first two months of the year continued to be under the influence of the restrictive measures adopted in connection with the ongoing COVID-19 pandemic, which have significantly affected primarily the service sector. As at the end of February, the government's budget posted a deficit of CZK 86.1 bn. Beyond the scope of the impact of economic developments and one-off measures, budgetary income is further weakened by a pronounced reduction in personal income tax collection, caused primarily by the abolition of the taxation of 'super-gross salary' and by increasing the basic tax credit[1]. The adverse impact of this change on the state budget are further deepened by a modification of the budgetary allocation of taxes in favour of municipal and regional budgets[2]. On the other hand, the slightly growing income from social security contributions operates as a stabilising element, which signals good resistance by the Czech labour market and the positive role of government support programmes (in particular, the Antivirus programme).

On 18 February 2021, the Chamber of Deputies of the Parliament of the Czech Republic approved a significant increase of the 2021 state deficit, from the original CZK 320 bn to CZK 500 bn. The change was made in order to take into account the impact of the tax package[3] and to release further funds in connection with the COVID-19 pandemic. Whereas the first reason is highly relevant and partially remedies the inappropriate approach to the budgetary process last autumn[4], in the second case, the CFC is of the opinion that it is a premature step. It would have been more appropriate to wait with the budget modification until economic results of Q1 are available, when the impact of the deepened

[1] The year-on-year decrease in aggregate revenues from personal income tax in the first two months of 2021 amounted to CZK 10 bn. In part, this is the result of the payment of a compensation bonus which is administrated as a tax refund.

[2] The coefficients expressing the share of the government budget in personal income tax, corporate income tax, and value-added tax were reduced by 3.12 p.p., as at 1 January 2021.

[3] Act No. 609/2020 Coll., amending certain acts in the sphere of taxes and certain other acts.

[4] See Opinion of the Czech Fiscal Council No. 8/2020, https://unrr.cz/wp-content/uploads/2020/12/Stanovisko-8_2020_Fisk%C3%A1ln%C3%AD-a-rozpo%C4%8Dtov%C3%A1-politika_A.pdf

epidemic closure in March will have already become manifest and when the parameters of the new support programme with the working title COVID 21 will have been clarified.

The continuous deepening of the public finance imbalance in 2020 and 2021, which is in many cases a consequence of steps not directly related to the COVID-19 pandemic (e.g., personal income tax reduction, abolition of the real estate transfer tax) unfortunately serves to bring forward the date of the collision with a debt brake. That will take place when a public debt level of 55% GDP is reached. With an effort to consolidate by 0.5% GDP per year in upcoming years (which is presumed by the current Act on budgetary responsibility rules) and a yet lower growth of the economy this year (as compared to current forecasts), a collision with the brake may occur as early as 2024. The application of the measures invoked upon reaching the brake, which are specified in the Act on budgetary responsibility rules[5], would considerably reduce the possibility to actively use fiscal policy for macroeconomic stabilisation, reduce the operation of many government sector organisations, and would also send a negative signal to financial markets. The CFC therefore takes the view that steps should be planned and taken now that will prevent the reaching of that threshold (see below).

Furthermore, the CFC takes the view that the present crisis differs from previous crises, in that it does not involve a drop in aggregate demand, but rather its artificial reduction, caused by the impossibility of making purchases in selected sectors. Fiscal policy should be adapted to this and it should, rather than stimulating aggregate demand as a whole, focus on ensuring adequate income for persons affected by the restrictive measures, on maintaining production capacity in closed or restricted sectors, and on positive stimulation leading to adherence to the measures imposed. In part, these objectives are already pursued by government programmes (e.g., compensation bonus, Antivirus programme etc.). Expenses incurred in these programmes do not constitute a major problem in the medium- and long-term, as they will be terminated after the pandemic and they will no longer pose a burden for the structural balance of public budgets. The number of these programmes, however, should be limited, because their excessive fragmentation makes for an unclear system and higher transaction costs.

The CFC also draws attention to the fact that the revenue as well as expenditure sides of public budgets should be adapted. It is necessary to assess whether all public budget expenditures are absolutely necessary in the present situation and whether it is not time to reduce some of them, shifting the saved funds to areas where they are needed more. A similar approach should also be applied to the revenue side of public budgets. Public budgets cannot be approached in the long term as if there were no crises, trying to implement all plans formulated in previous years when macroeconomic forecasts had assumed solid economic growth. The outcome is a high dynamic of deepening structural deficits[6] which should be at least slowed. This is not a recommendation to engage in a fiscally restrictive policy, which would not be appropriate with a view to the condition of the economy, but rather, a restriction of the scope of new and existing measures that serve to deepen the structural deficit.

On the basis of the above and, above all, with a view to the nearing date of collision with the debt brake, the CFC recommends that the government prepare a realistic consolidation strategy. It is evident that the scope of consolidation efforts between 2022 and 2024 will need to be greater than 0.5% GDP per year. It is also evident that the consolidation will require a significant increase of the tax burden, as the longer-term outage in revenue amounting to the tax package cannot be fully covered by a reduction in expenditures (unless a significant reduction is taken in the largest blocks of

[5] See Section 14 of Act No. 23/2017 Coll., on budgetary responsibility rules.

[6] The Czech Ministry of Finance expects a worsening of the structural balance by 3.9% of GDP between 2020 and 2021. This estimate was, however, made before the amendment of the 2021 National Budget Act. See MF CR (2021): Macroeconomic Prediction of the Czech Republic, January 2021, p. 12.

expenditures – social security, healthcare, and education, which the CFC does not assume). The CFC considers arguments that this will be a task for the future government to be incorrect and inappropriate, because, with this logic, there would be no sense in drawing up any strategic documents that go beyond one election term. Furthermore, it must be stated that, for example, the rating agency Moody's, when it confirmed an Aa3 rating for the Czech Republic, states as a condition for its retention in upcoming years the implementation of such a strategy[7].

A realistic consolidation strategy is required, because after 2030, public finance will start to be subject to strong pressures arising from the continued population ageing. Hence, it is in the interest of the Czech Republic to enter that stage with as low a debt as possible. In that context, it is evident that there will need to be a modification in the pension system as, in its present form and with the current level of revenue, it would result in a deepening of deficits after 2030 to an unsustainable level. The proposals for pension system transformation that have been presented thus far unfortunately do not address the issue of ensuring financial sustainability.

[7] https://www.moodys.com/research/Moodys-affirms-the-Czech-Republics-Aa3-ratings-and-maintains-stable--PR_439412