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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.

Basic economic situation

Refined GDP estimate for Q2 of this year has shown that the Czech economy dropped by 11% in that period, year on year. The predominant cause of the drop was a 23.3% decline in exports, which was due to weaker foreign demand as well as domestic measures related to the COVID-19 pandemic. According to international trade statistics, the drop in exports was pronounced in April and May, whereas June brought a positive turn. Q3 should confirm that tendency.

Household consumption was down by 7.6% between April and June, having contributed two percentage points to GDP decline. According to the Czech Statistical Office (CSO), consumption of durable and semi-durable goods was down in particular, as well as expenditures on services, which is a natural repercussion of epidemiological measures and which creates room for deferred consumption. June retail data and August data on consumer confidence indicate a slight revival already. Household consumption as well as consumer confidence are, at the same time, under the influence of fear of inflation, the future financial situation of the population, and unemployment.

Investments as a whole were down by 4.8% in Q2, year on year, but development across sectors differed. Whereas investments in machines and means of transport were down, statisticians noted growth in the case of buildings and structures. One of the reasons is the fact that the construction sector was not hit by epidemiological measures as strongly as the rest of the economy. Most previously started projects carried on. Insufficient workforce may remain a barrier for further development of the segment. For investments, the general prediction of development in the rest of the year is less certain than that for consumption or exports; much will depend on the development of business confidence and the state's ability to increase its investment expenditures.

The labour market is also currently marked by strong uncertainty. Current unemployment data, however, do not give cause for any serious concern, as of yet. As at the end of July, the share of unemployed persons amounted to 3.8%, the same value as the pre-crisis all-time low of May 2008. An increase in the number as well as the share of unemployed persons can likely be expected after the Antivirus government support programme is terminated, but if shorter working hours, known as "kurzarbeit", are integrated in labour law, unemployment in upcoming months should not exceed 5%.

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

As at the end of August, the government budget noted a record deficit of CZK 230.3 bn. In July and August, however, the deficit deepened far slower than between March and June, and it is evident that government finances reflect tendencies visible in the real economy. Furthermore, it was confirmed that the third amendment of the 2020 government budget act, increasing the approved deficit from CZK 300 to CZK 500 bn, was premature, unfounded, and excessive.

In connection with the economic downturn, the government proposed an increase of the government budget deficit to half a billion crowns in June, arguing that it is necessary to have sufficient funds for combatting the economic consequences of the pandemic. Originally, the deficit increase was comprised of CZK 63 bn of a drop in tax income and CZK 137 bn of an increase in government budget provisions. Since the beginning, the CFC has considered this volume of unspecified provisions to constitute a reduction in public finance transparency and reduction of parliamentary control. In the end, the government at least partially earmarked the expenditures to individual envelopes by making an amendment, but CZK 36 bn remained as a budget provision.

Even though it had been stated that the reason behind the deficit increase is particularly the need to "invest our way out of the crisis", the increase in capital expenditure only amounted to CZK 30 bn. The actual impact on investment activity will probably be yet lower, because some of the funds are earmarked for the State Fund for Transport Infrastructureas a compensation for an outage of its income due to the economic downturn. Hence, these are not resources for new investments, but coverage for projects already in the pipeline. Furthermore, it can be assumed that some of the investment projects envisaged will not even be launched by the end of the year, as the projects will not have been sufficiently prepared, the requisite permits will not have been obtained, and the tender procedures may drag due to appeals of unsuccessful bidders.

The government now intends to use the funds additionally gained, thanks to the above-mentioned deficit increase, not only for continuing certain stabilisation measures, but also to finance a one-off contribution of CZK 5,000 for all pensioners. The outcome will be additional expenditures of CZK 15 bn. The CFC is of the opinion that, in the present economic situation, only those expenditures should be made that will best stimulate aggregate demand or at least partially mitigate the adverse impact of the crisis on the incomes of affected households. The income of pensioners' households does not, however, meet that criterion, as they have not been affected by the crisis[1]. On the other hand, we must note that the solution chosen, in the form of a one-off contribution, is more favourable in terms of public finance sustainability than the originally considered excess pension valorisation, as it will not be carried over to subsequent years.

[1] The argument pointing to the stress level, in particular in the context of the fact that research (see, e.g., https://idea.cerge-ei.cz/vystupy/dopady-pandemie-koronaviru-na-dusevni-zdravi) has shown a significantly greater level of stress in other types of households, is very problematic. Also, another argument for the exceptional raise in pensions – higher inflation affecting pensioners' households than the general inflation level – is not relevant. The present valorisation mechanism takes that fact into account, as the higher of the two values is used exclusively in calculating the rate of growth of pensions.

In connection with the above-mentioned measure, the CFC is of the opinion that the government should primarily focus on modifying the existing pension system, to be able to guarantee an adequate standard of living to old-age pensioners after 2030, when the age structure of the population will start to change significantly, to the detriment of economically active persons.

Another measure proposed that would have a significant impact on public budgets as of next year is undoubtedly the departure from the concept of super-gross wage taxation, and the simultaneous establishment of two individual income tax brackets, with rates of 15% and 23%. CFC calculations show that if the tax base of employees were reduced to gross wage and the above-mentioned rates applied (with all other parameters remaining constant), the direct outage of public budget revenues would amount to around CZK 92 bn. The state budget accounted for two-thirds of this amount, local government budgets for the rest. The actual impact on public budgets would probably be slightly lower, though, as consumer household expenditures would increase by a portion of their additional income, and with the collection of VAT and excises. The estimates proposed by government representatives operate with approximately CZK 15 bn in additional income.

The CFC considers the proposed regulation of personal income tax inappropriate, given the present economic situation, for several reasons. In terms of the stabilisation function of public finance, whose objective should be, in the present economic situation, maximum stimulation of aggregate demand, support with direct government expenditure (for example, investments) seems more appropriate than increasing household disposable income. There is a realistic possibility that households, expecting an adverse development of the economy, will put a significant portion of their "new" income away and the value of the multiplier[2] will be very low[3]. This will jeopardise the expected additional VAT and excises revenues, used as an argument by the bill's movers.

Another major problem plaguing the solution chosen is its impact on budgets of local government units, which would lose as much as CZK 30 bn (or CZK 25 bn if the higher VAT and excises collection materialised, as assumed by the government). This would constitute a major intervention in their budgets and municipalities and regions can be expected to reduce their investment spending.

From the macroeconomic point of view, pro-cyclic behaviour would be supported, which cannot be considered desirable. Furthermore, we must note that public investments from local budgets account for nearly one-half of all public investments. In order to prevent the above-mentioned effect, local budgets would require a compensation by means of an adjustment of the budgetary designation of taxes, to the detriment of the state budget. Therefore, to go the route of an increase in the scope of specific subsidy programmes cannot be recommended, as it is an expensive and time-consuming process. Furthermore, local decision-making would be restricted. Hence, it is evident that any tax outage due to an personal income tax reduction would be borne primarily by the state budget.

Furthermore, the CFC warns that unless tax credits and allowances are modified when personal income tax is changed, the progressiveness of the Czech tax system would be reduced, i.e., net income of higher-income households would grow more than that of low-income households[4].

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[2] The multiplier expresses the ratio of GDP change to the value of the fiscal impulse, which may be both an increase in public spending and tax cuts. Its value in fiscal expansion may be deemed to constitute an indicator of fiscal policy.

[3] Empirical studies generally confirm that the values of expense multipliers are higher than those of tax multipliers.

[4] According to CFC calculation, the Gini coefficient calculated from net disposable income would grow from 0.2314 to 0.2384.

Another problem involved in a significant reduction of personal income tax is the attempt to reduce high taxation of labour inappropriately. Certainly, its reduction is desirable in the Czech Republic, but the main problem of labour taxation is statutory social and health insurance contribution, rather than income tax. In fact, income tax is already relatively low in an international comparison, whereas the prominence of social and health insurance contribution is above average[5]. Hence, it is evident that a reform of labour taxation should focus on social and health insurance contribution[6] rather than on personal income tax. Furthermore, this adjustment should better be made as a part of a comprehensive modification of the income side of the pension system, in order for it to be better prepared for the consequences of demographic change.

Furthermore, the CFC notes that this personal income tax adjustment without a significant increase of other public revenues or reduction of public expenditure jeopardises medium and long-term sustainability of public finance. Public budgets are already finding themselves in a structural imbalance of approximately -2% GDP and this measure, even with a certain offset in the form of increased income from consumption taxes, would deepen it further by approximately 1.4 p.p. Furthermore, the discussed abolition of the real estate acquisition tax will have further adverse impact on the structural deficit (approx. 0.2 p.p.)7, so the value of structural deficit in 2021 from these two measures alone can be estimated at 3.6%. This kind of worsening of the structural balance is, however, not sustainable even with the looser fiscal policy limits in the next 7 years, introduced in 2020 by an amendment act on budgetary responsibility rules. In 2022, the limit is set at -3.5% GDP and it is slated to tighten by another 0.5 p.p. every year. The figures given above indicate that such an intervention is sustainable for a maximum of one year, and it will essentially erase all room for increasing investment expenditures covered from national resources and other measures for stimulating the economy. The CFC generally thinks that in the present economic situation and with the present state of public budgets, the proposed method of personal income tax modification is inappropriate and involves significant risks.

Both measures proposed (one-off contribution for pension insurance beneficiaries and personal income tax reduction) unfortunately point to the adverse impact of loser fiscal policy introduced by an amendment of the act on budgetary responsibility rules and the approval of a deficit of CZK 500 bn. In both cases, the CFC warned that the measures are premature and excessive and that it would be more appropriate to wait for first data indicating the economy’s development in Q2.

This concept of fiscal policy will unfortunately not ensure the use of public funds borrowed on capital markets with a maximum effect for aggregate demand, but rather, it should be classified as a self-serving measure unrelated to the COVID-19 pandemic and struggle with its economic impact, which was the main argument for loosening fiscal rules. Furthermore, the CFC sees as very problematic the fact that the measures are discussed separately, rather than evaluated in the context of a medium-term strategy for public budget consolidation which the government is to present to the Chamber of Deputies by 30 September 2020.

[5] The share of social and health insurance contribution in GDP is around 16% in the Czech Republic (14.6% net of the impact of payments for state-policyholders), whereas in all of EU it is 13.3%; on the other hand, the share of revenues from personal income tax in GDP is around 4.6% in the Czech Republic and 8% in the EU.
[6] Reduction in compulsory insurance contribution would also make it possible to increase income for low-income households far more easily, as they can be expected to be more prone to consumption. This would result in greater stimulation of aggregate demand than the proposed solution in the form of personal income tax cuts.
[7] This further reduces the progressivity of the Czech tax system.

The CFC is of the opinion that the government should be far more restrained in assuming debt and should have an analysis of economic impact available for each measure it considers. The basic criterion for adopting changes in tax and expenditure policies should be a targeted effort to stabilise the income of entities affected by the economic downturn and a focus on those areas where there is greatest potential for stimulating aggregate demand.

With a view to the present situation, with a relatively stable labour market (in part thanks to the measures taken), the route of supporting aggregate demand by a gradual increase in investment spending seems more rational and sustainable, as it can generate demand, in particular in the construction sector, for the workforce gradually released from affected sectors. Furthermore, it can be recommended that stimuli be created, especially in tax and expenditure policies, that would make economic entities expedite certain spending (e.g., temporarily faster depreciation).

In preparing the 2021 budget, the CFC recommends that the total limit of government budget and state fund spending, derived pursuant to the act on budgetary responsibility rules, not be exhausted in full[8]. If the government reach the limit, the 2022 budget will have to be fiscally restrictive (i.e., it will need to involve either a tax raise or a reduction of certain expenditures, or a combination of the two), which may be potentially inappropriate from the macroeconomic point of view, given that future economic development is yet unknown. At this point, nobody knows exactly how fast recovery from the impact of the present crisis will be and whether room will not be necessary for fiscal stimulation of the economy in 2022 as well.

[8] Complete exhaustion of the limit would mean targeting a structural deficit of 4 % GDP.