The Czech Fiscal Council

Office of the Czech Fiscal Council

CZECH FISCAL COUNCIL

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OPINION

of the Czech Fiscal Council

Number 1/2024

dated 7 March 2024

<u>on public sector finances and fiscal and budgetary policy</u>

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 (hereinafter "CFC") monitors general government finances. As part of this activity, it also seeks to identify risks that may negatively affect the stability of public finances in the short, medium, and long term. Since September 2018, the CFC has been informing the public of its conclusions on a quarterly basis.

Economic background

Gross Domestic Product (hereinafter "GDP") continued to fall in the final quarter of 2023, by 0.2% year-on-year. However, it grew by 0.2% quarter-on-quarter, with positive contributions from gross fixed capital formation (1.1%), external demand (2.2%) and even household consumption (0.5%). The year-on-year fall in GDP in 2023 (–0.4%) was due to a fall in inventories and a very weak consumer demand (–3.1%). It is worth noting that gross value added (hereinafter "GVA") grew year-on-year in all four quarters last year (+0.6% year-on-year in 2023), while GDP declined year-on-year in all quarters. Manufacturing and information and communication activities were the main contributors to GVA growth, while trade, transport, hotels and restaurants contracted.

Whether we look at the first or the second indicator to assess the performance of the economy, the Czech Republic was the worst country in the EU at the end of 2023 compared to its pre-pandemic level in 2019. The second worst economy from this perspective was Germany. Moreover, after a whole year of stagnation, the German economy was one of the few European and global economies to actually contract quarter-on-quarter in the fourth quarter (–0.3%). In December, German industrial production fell month-on-month for the fourth month in a row (–1.6%) and retail sales also fell for the third time in a row (–0.4%) in January. In 2024, Germany should achieve only a weak recovery and GDP should grow by 0.5%. The uncertain development of the German economy this year also poses a significant risk for the Czech Republic, as it accounts for a substantial part of Czech external demand. The CFC mentions this risk in the context of the development of the Czech public finances. If the domestic economy grows more slowly than the forecast of the relevant institutions suggests (the Ministry of Finance, hereinafter "MoF", and the Czech National Bank, hereinafter "CNB"), the likelihood that the general government deficit will be higher than the 2.2% of GDP announced by the MoF increases. (Other risks concerned with general government deficit are described below.)

Gross domestic product in the Czech Republic is expected to grow by around 1% in 2024, with a recovery in household consumption following annual real wage growth of around 3%. Quarter-on-quarter real wages have been rising for the last three quarters, and from the end of 2022 to the end of 2023 real wages grew by 2.1% (excluding the effect of the so-called "saving tariff"). The overall unemployment rate rose to 3.0% (by 0.2 pp) and the share of unemployed to 4.0% (by 0.3 pp) in January. Unemployment is expected to remain at these levels throughout the year.

The good news is that inflation has fallen significantly. The annual inflation rate fell to 6.9% in December (even to 4.2% if the "saving tariff" is excluded from the calculation). The traditional January revaluation was lower than expected, resulting in an annual inflation rate of 2.3% in January. This marks a return to the tolerance band of the CNB's inflation target for the first time since June 2021. In addition, agricultural producer prices fell by 19.8% year-on-year in January and industrial producer prices were down by 1.8% year-on-year. However, it is crucial for the macroeconomic situation that low inflation is maintained in the future.

General government finances and fiscal policy framework for the coming years

As in previous years, no significant conclusions could be drawn at the end of February about the final balance of the general government sector for the whole year. Although the state budget ended with a relatively high deficit of CZK 102.5 bn in February (CZK 102.3 bn adjusted for funds on programmes and projects from the EU budget, including financial mechanisms), this figure is characterised by the fact that revenue and expenditure flows are not evenly distributed over time. Tax revenues are currently growing by 9.4% a year, and social security contributions by 7.6%, although this figure is affected by the introduction of sickness insurance for employees. Indirect taxes also show solid year-on-year increases (value added tax 7% and selective excise duties 11.2%), reflecting both the growth in household consumption and the legislative adjustments adopted as part of the so-called “consolidation package”.

This year should be the year when the Czech general government deficit falls below the 3% of GDP threshold. The January macroeconomic forecast foresees a deficit of 2.2% of GDP. However, its achievement depends on the government's caution regarding possible increases in expenditures on education, agriculture, or the Ministry of the Interior, which are currently under discussion. The possible increase in state budget expenditures, using entitlements from unspent expenditure, is obviously a factor acting in the direction of higher deficits.

Also on the revenue side, risks on the downside can currently be identified. These relate to revenues from the EU Emissions Trading System (EU ETS), where it is highly unlikely that the budgeted amount (CZK 40.7 bn) will be reached, given the significant decline in their price[1] and the possible activation of the levy to the market reserve. The gradual deterioration in this year's forecast of economic growth also works in the direction of a reduction in expected tax revenues, as the August 2023 macroeconomic forecast, on which this year's state budget was based, assumed real GDP growth of 2.3%, while the current (January 2024) macroeconomic forecast considers a value of only 1.2%.

For the balances of the other parts of the public budgets, on the basis of the submitted health insurance plans and the additionally approved expenditure, health insurance companies are expected to end the year with a slight deficit compared to the initially expected slight surplus in the original forecast. The expected lower economic growth will also affect the performance of local governments, leading to lower surpluses in this subsector.

In the context of a somewhat restrictive fiscal policy, there are already pressures to loosen it, for example in the form of the above-mentioned additional expenditure requirements from the state budget, as well as in the form of proposals for unsystematic new tax relief or discount on statutory social security contributions. In this case, the CFC notes that the approved consolidation should continue. Efforts to dilute the current fiscal policy could reduce the beneficial effects of the adopted consolidation package already in the first year of its validity.

In early March, the Ministry of Labour and Social Affairs presented a proposal for significant changes to the parameters of the pension system. The proposed measures (linking the retirement age to the increase in life expectancy and adjusting the assessment of new pensions) are mostly aimed at improving long-term sustainability and (if implemented and sustained) represent an important precondition for reducing the deficit pressures caused by demographic change from the mid-2030s

[1] In August 2023, the price of one allowance was around €90, but during February 2024 it dropped to €55.

onwards. The CFC supports the proposed measures as a whole but sees the introduction of early retirement as a certain risk, where – from the point of view of both fiscal sustainability and social justice – it is necessary to link this relief to a specific job and workplace, rather than to a more generally defined profession.