Office of the Czech Fiscal Council

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<u>on development of general government 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 informed the public of its conclusions on a quarterly basis.

Initial economic situation

The Czech Republic's gross domestic product (GDP) grew by 0.7% quarter-on-quarter (q-o-q) in the final quarter of the last year. Growth was driven exclusively by a rebound in household consumption (1.5%), while gross fixed capital formation pushed GDP down (–1.5%). In annual terms, GDP rose by 1.8%. Gross value added (GVA) offers a different picture of the economy's performance. At the end of the last year, it stagnated q-o-q (0.0%) and grew by only 1.1% year-on-year (y-o-y). There was evident divergence between the expanding services sector and the manufacturing sector, which is experiencing a decline (–1.5% y-o-y). The different dynamics of GDP and GVA suggest the drop in economic activity was not so significant in 2022 and 2023 and there was not such a strong recovery in 2024.[1]

Average gross wages reached CZK 46,165 last year. In nominal terms, it rose by 7.1% y-o-y, and by 4.6% in real terms. The labour market remains stable. The seasonally adjusted unemployment rate remained at 2.7% in January which means y-o-y decline by 0.3 pp.

January repricing followed the long-term average and consumer prices rose by 1.3% month-on-month (m-o-m), with prices of goods rising by 1.5% and prices of services by 1.0%. The dynamics of goods prices was largely driven by food prices, which rose by 3.0% m-o-m. In addition, agricultural producer prices rose by 1.5% m-o-m in January, accelerating their y-o-y growth to 9.1%. The y-o-y inflation rate was 2.8% in the first month of the year.

The German economy experienced very cautionary last quarter of 2024. It fell by 0.2% y-o-y and also q-o-q. Only government consumption (up 4.0% y-o-y) prevented a bigger fall. However, the GVA of the German economy even fell by 1.4% y-o-y in the fourth quarter. The largest contributors to the decline were the construction (–3.2%) and manufacturing (–2.8%) sectors.

[1] The difference between GDP and GVA is the dynamics of indirect taxes and subsidies.

General government finances and fiscal policy settings for the coming years

The situation of the Czech general government finances is currently developing similarly to last year. The imbalance is dominantly concentrated in the state budget, which recorded a cash deficit of CZK 68.6 billion in the first two months. However, the balance after adjusting for the impact of revenue and expenditure related to EU projects was CZK 8.1 billion worse at CZK –76.7 billion. This is the only relevant indicator for comparison with the approved balance. On the revenue side, the personal income tax and social security contributions show solid y-o-y growth of 11.8% and 7.7% due to wage growth. In the case of consumption taxes, a recovery in household consumption demand is also evident, with value added tax (VAT) revenue increasing by 6.4% y-o-y and selective consumption taxes revenue by 14.3%.[2] On the expenditure side, no significant deviations from the approved values can be identified so far.

However, developments in the last few weeks point to the fulfilment of some risks related to non-respecting of the principles of sound budgeting. The CFC pointed this out in its Statement on the Draft State Budget for 2025.[3] On the revenue side, the likelihood of non-fulfilment of revenues from the sale of emission allowances, where the state budget envisages a total amount of CZK 30 billion, is increasing. As the CFC has previously stated, this amount could only be reached if the average price of an emission allowance is around EUR 104. After an increase at the beginning of this year, when the price of an allowance on the primary market exceeded EUR 80, it is now falling to below EUR 70. The likelihood of achieving the expected revenues may be further negatively affected by the possible transfer of allowances to the market stability reserve (MSR) from August of this year. While the withdrawal of allowances to the MSR may result in an increase in the allowance price, the reduction in the quantity of allowances the Czech Republic can auction during the year has a more significant impact on revenues.

On the expenditure side, it will be necessary to cover the financing of non-teaching staff and other non-investment expenditure in regional education for the whole year, and not just until August as envisaged in the state budget. The reason for this is the intention to change the method of financing and the related adjustment to the budgetary determination of taxes has been postponed. The adjustment should take place from 1 January 2026. This means additional expenditure of CZK 10.5 billion from the state budget, which is not foreseen in the relevant expenditure indicator. This fact confirms the need to respect the principle of budgeting only based on legislation already in force, not on the basis of proposals or even mere intentions.

A similar problem of under-budgeted expenditure also emerges in the case of expenditure on support for renewable energy. The reduction of the volume of funds in the state budget to CZK 8.5 billion from the originally requested value of over CZK 30 billion was justified by the fact that four measures aimed at limiting support for photovoltaic power plants commissioned in 2009–2010 would be approved. However, in the final form of the amendment to the Act on Supported Energy Sources, only two of them (individual assessment of the internal rate of return and extension of the period for which the calculation is carried out) remained. In the opinion of the CFC, those do not have great potential fiscal impact. Unfortunately, more precise estimates of the potential fiscal impact of each change are still not available from the government. It is therefore highly probable the amount of funds budgeted for this support will have to be significantly increased.

In the case of the other components of the general government budget system, municipal and regional surpluses can be expected to continue as in previous years. At the level of the public health insurance companies, the trend towards moderate deficit financing continues, with health insurance plans projecting a deficit of around CZK 12 billion (around 0.15% of GDP). The deficit will be covered by health insurance companies' financial reserves from previous years, which are gradually running out. According to the health insurance plans for 2025, the biggest problems can be expected for the Military Health Insurance Company, where the value of overdue liabilities is expected to increase to

[2] The y-o-y increases in the collection of personal income tax and VAT might be different at the state budget level. This is a consequence of changes in the budgetary determination of taxes (state budget vs. regional and municipal budgets).

[3] https://www.rozpoctovarada.cz/en/publications/statement-of-the-cfc-on-the-draft-state-budget-for-2025/.

CZK 2.9 billion. The CFC therefore stresses out the reduction in the growth rate of expenditure will be necessary to achieve sustainability of the public health insurance system.[4]

An important issue which will fundamentally affect general government finances in the short and medium term is the expected increase in defence spending and the need to take it into account in the fiscal rules. The CFC believes the growth of this expenditure caused by the worsening geopolitical situation and by the underfunding of the military in the past decades due to the non-compliance with our commitments[5] will not be possible without adjustments to both national and EU rules. At the national level, the CFC considers that the appropriate solution is to amend Act No. 23/2017 Coll., on the Rules of Budgetary Responsibility in a way which will enable the expenditure framework of the state budget and state funds to be increased for the expenditures exceeding 2% of GDP on defence. In other words, above the level considered optimal in peaceful times. Given the need for an immediate response, it is not realistic to assume that it would be possible to quickly offset the increased military expenditure by reducing other major expenditure items, and thus to manage everything within the current rules. However, the CFC believes that in the medium term, given the fiscal space, all major spending programmes (defence capability enhancement, decarbonisation, energy sector, transport infrastructure, etc.) cannot be implemented simultaneously, and it will be necessary to limit or at least reduce the annual growth rate of funds flowing into non-military activities.[6]

[4] In this context, it should be mentioned that the Government Resolution No. 267 of 24 April 2024 on the Budgetary Strategy of the General Government Sector of the Czech Republic for 2025–2027 instructed the Minister of Health to issue a decree on setting the value of the point of reimbursement for covered services and regulatory limitations for 2025 in such a wording that will enable balanced finances of the public health insurance system in 2025.

[5] The ten-year (2014–2023) average of the defence expenditure as a share of GDP is only 1.2%, which is 40% below the value of the NATO membership commitment.

[6] In the context of military spending, the CFC also draws attention to the need not to postpone the necessary purchases, as delivery times are very long both due to the limited capacity of the supply side and the nature of the production cycle of advanced weapon systems.