The Czech Fiscal Council

Office of the Czech Fiscal Council

CZECH FISCAL COUNCIL

-

OPINION

of the Czech Fiscal Council

Number 4/2024

of 13 June 2024

on general government finances and fiscal and budgetary policy

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 budgets in the short, medium, and long term. Since September 2018, the CFC has been informing the public of its conclusions on a quarterly basis.

Initial economic situation

Gross domestic product ("GDP") increased slightly for the second consecutive quarter in Q1 2024, both in year-on-year ("y-o-y") and quarter-on-quarter ("q-o-q") terms. Annual growth of 0.2% was driven mainly by household consumption (+0.9 pp) and the international trade in goods (+2.7 pp), where the growth was mainly driven by motor vehicle exports. Conversely, gross capital formation (i.e. simplified "investment") negatively affected GDP (–0.7 pp), as gross fixed capital formation fell in y-o-y terms for the first time since Q1 2021. A significant part of the y-o-y change in real GDP is accounted for by the balancing item called *changes in inventories* (–3.4 pp). Quarter-on-quarter GDP growth of 0.3% was driven exclusively by household consumption, which rose q-o-q the most since Q3 2021, but growth was dampened by a sharp q-o-q decline in gross fixed capital formation (–7.9%). The negative investment dynamics is most likely due to the transition to the new financial perspective of EU funds and the associated temporary decline in government investment.

However, gross value added ("GVA") fell by 0.7% y-o-y and by 0.1% q-o-q. The decline in GVA while GDP grew was due to an increase in the *balance of taxes and subsidies*. The balance increased due to a fall in *subsidies on products*, which is linked to the end of energy interventions.

While the annual inflation rate was 2.0% in March, it accelerated to 2.9% in April. This acceleration was mainly driven by food prices, which slowed their y-o-y decline, while the sharp fall in food prices at the beginning of the year was key to the decline in inflation. Average nominal seasonally adjusted wages rose by 1.7% q-o-q in Q1, as wages continued to rise in real terms q-o-q. On a y-o-y basis, nominal average wage rose by 7.0% and, given the significant decline in inflation, wages in real terms rose y-o-y for the first time in two years (by 4.8%)

Retail sales were unchanged month-on-month ("m-o-m") in April and increased by 5.3% y-o-y. Thus, after 5.8% growth in March, a rise slowed slightly. In January–April 2024, the international trade in goods reached a surplus of CZK 117.6 billion (y-o-y growth of CZK 68.4 billion), which was mainly favourably influenced by trade in motor vehicles. Industrial production rose by 0.6% m-o-m in April.

General government finances and fiscal policy settings for the coming years

The state budget continues to suffer from a significant imbalance, albeit lower than last year. Its deficit reached CZK 210.4 billion at the end of May (CZK 198.7 billion after adjusting for funds on programmes and projects from the EU budget, including financial mechanisms). A deficit of CZK 252 billion was approved for this calendar year.[1] However, the better picture about the development of the state budget (and about the realism of keeping to the approved deficit) will be provided by the summer months, as the corporate income tax surcharges from large entities will be collected.

According to the CFC, tax revenues are broadly in line with expectations, especially the most important tax categories such as social security contributions, value added tax and personal and corporate income tax. A similar evolution can be observed so far on the expenditure side of the state budget, with the main expenditure items roughly holding their aliquots.

Nevertheless, the CFC identifies a number of risks that could put the state budget under significant pressure in terms of meeting the approved deficit. These include revenues from EU Emissions Trading System ("EU ETS"). The state budget foresees a revenue of CZK 41 billion. However, given the fall in realised prices (compared to last year's expectations), and the European Commission's announcement on the number of withdrawn emission allowances[2], revenue this year can be expected to be around CZK 25 billion lower. In this context, the CFC points out that the problem of correct budgeting of revenues from the sale of EU ETS was also an issue in the state budgets of previous years[3], and it is therefore necessary to improve its quality and transparency.

Another risk is the public consideration of some ministries to increase current budget expenditures (e.g. valorisation of salary scales in the public sector) this calendar year. The CFC does not see any significant room for increasing budget expenditures in this year's budget. If there were to be an increase in expenditure at any ministry, the CFC believes that there must be an adequate reduction in expenditure in another ministry, as the scope for dealing with this by using entitlements from unspent expenditure is limited. Furthermore, the CFC points out that the current wording of the Act No. 23/2017 Coll., on the Rules of Budgetary Responsibility, requires a further reduction of the structural deficit, and therefore the discussion on increasing expenditure must be approached very cautiously.

At the end of April, the local government's financial position reached a positive balance of almost CZK 30 billion. Of these, regional budgets showed a surplus of CZK 10.5 billion, while municipal budgets showed a surplus of CZK 18.4 billion. According to the CFC, it is likely that local government units will continue to manage a relatively high surplus this year, which could be around 0.8% of GDP, especially considering the slight improvement in the macroeconomic forecast published by the Ministry of Finance of the Czech Republic in April. The CFC believes that the long-standing high surpluses of local government units in all phases of the business cycle are not macroeconomically sound and do not lead to an efficient use of the funds collected from taxpayers[4]. In many cases, these surpluses remain in bank accounts and taxpayers do not benefit from it in the form of public goods or services. The CFC therefore recommends a discussion to be initiated on a more rational use of these resources and on the distribution of tax revenues among the various components of the public budget system.

The CFC continues to monitor the process of changes in the pension system set-up, as it supports the changes as a whole. The CFC believes that adjustments to the parameters of the pension system are necessary if the pension system is to remain sustainable in the long-term horizon. A more detailed analysis of the impact of the adopted parametric changes to the pension system (also in the light of the current demographic projections of the Czech Statistical Office) will be presented by the CFC in September in the report on the long-term sustainability of public finances.

---

[1] Another imbalance at the central level of the government is represented by the approved deficit of the State Fund for Transport Infrastructure.

[2] This is the withdrawal of emission allowances to the so-called Market Stability Reserve, which is announced by the European Commission each mid-year based on the total amount of emission allowances in circulation. The allowances are being withdrawn from September 2024 to August 2025 and will affect the quantity of allowances originally announced in the auction calendar for this year.

[3] In 2022, revenue of CZK 19.9 billion was budgeted, the reality was CZK 16.4 billion. In 2023, CZK 32.5 billion was budgeted, the reality was only CZK 18.6 billion.

[4] High surpluses are also characteristic of previous years: 1.0% of GDP in both 2022 and 2023.