The Czech Fiscal Council

Office of the Czech Fiscal Council

CZECH FISCAL COUNCIL

-

O P I N I O N

of the Czech Fiscal Council

Number 4/2025

12th June 2025

on development of 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 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

Gross domestic product (GDP) rose by 0.8% quarter-on-quarter (q-o-q) in the first quarter of 2025 (Q1), its highest growth since the fourth quarter of 2021. Net exports (+0.6 pp) and gross fixed capital formation (+0.3 pp) contributed most to growth, while government consumption had a negative impact (−0.3 pp) and household consumption stagnated. Gross value added (GVA) grew by 1.3% q-o-q, its highest growth since the third quarter of 2021. The mining and quarrying (+0.6 pp) and financial and insurance activities (+0.2 pp) were the strongest contributors to GVA growth. Annual GDP growth of 2.2% in Q1 was mainly driven by household consumption (+1.1 pp) and inventory formation (+1.2 pp). In annual terms, GVA rose by 2.5%. The high growth rate of the Czech economy in Q1 means that if it were to stagnate for the rest of the year, it would record annual growth of 1.6% in 2025.

In April, industrial production increased by 0.9% month-on-month (m-o-m) in real terms and by 2.0% year-on-year (y-o-y). Thus, the industry sector grew for the third month in a row. April's growth, like February's and March's, was mainly influenced by the low y-o-y base in electricity production. Retail sales rose by 1.2% m-o-m in April, with sales driven mainly by the food, which saw a 2.4% increase. Sales in services rose in April by 0.5% m-o-m. The strongest m-o-m growth was recorded in accommodation and food services (2.0%) and information and communication activities (0.9%).

The average wage rose by 3.9% y-o-y (in real terms) in Q1, while the median wage rose by 2.5%. Consumer prices rose by 0.5% m-o-m and by 2.4% y-o-y in May. Inflation was mainly driven down by energy prices. Electricity prices fell by 4.6% y-o-y and natural gas by 8.4%. The unemployment rate has stood at 2.7% since the beginning of the year and was 0.1 pp lower y-o-y in April.

The trade surplus reached CZK 106.2 billion in January–April 2025, down by CZK 6.9 billion y-o-y. In April, the first y-o-y decline in exports this year was recorded. From a commodity perspective, exports of machinery and equipment fell the most, and from a territorial perspective, exports to Germany declined. The German economy stagnated y-o-y in Q1, ending a six-quarter run of y-o-y economic contractions. On a q-o-q basis, German GDP grew by 0.4%, the strongest growth since the third quarter of 2022, supported by an unexpected increase in manufacturing output (1.0% q-o-q). However, industrial production fell as expected in April, correcting the growth stemming from the build-up of inventories for the US market in the previous month.

General government finances and fiscal policy settings for the coming years

The Czech public finances continue to show a clear imbalance at the level of the state budget, which ended up with a deficit of CZK 170.5 billion at the end of May, while the balance adjusted for the impact of revenues and expenditures related to EU projects was CZK 3.9 billion more unfavourable. On the revenue side, the personal income tax maintained its high dynamics (+13.1% y-o-y), which is mainly related to the relatively high nominal wage growth. This is also reflected in the growth of social security contributions (+7.6% y-o-y). Solid results can also be seen in consumption taxes, where VAT revenue increased by 6.2% y-o-y at the national level and excise duties by 5.2%. On the expenditure side, the main expenditure items have not deviated significantly from the approved values so far.

However, despite the above, it should be noted that the risks highlighted by the CFC are starting to materialise. A significant shortfall can be expected in revenue from the sale of emission allowances (EU ETS). At the end of May, the European Commission (EC) announced the withdrawal of emission allowances to the Market Stability Reserve (MSR) from September this year to August 2026, which means a reduction in the volume of allowances allocated for sale to the Czech Republic.

Fulfilling the revenue from the sale of emission allowances, when the state budget expects a revenue of CZK 30 billion, is thus practically impossible and, given the current development of EU ETS prices, the revenue can be expected to be about CZK 16 billion lower. At the same time, the withdrawal of allowances to the MSR will affect the number of allowances and the expected revenue from their sale in the next year, and therefore the medium-term outlook for the expected revenue of the general government sector will need to be adjusted in the August update of the expenditure framework of the state budget and state funds.

On the expenditure side, the government's budget reserve, amounting to CZK 7.9 billion for 2025, was fully utilised[1]. This is mainly the result of the transfer of CZK 6 billion to the Ministry of Industry and Trade for subsidies for renewable energy sources (RES). In line with the earlier warnings of the CFC, it turned out that the RES subsidies were not budgeted in a sufficient amount. Thus, the state budget has no reserve to cover unexpected expenditures before the middle of the year, which the CFC considers problematic. Thus, in case of unexpected events, it will be necessary to find resources by transferring from other items or by involving claims arising from unconsumed expenditure. However, the use of claims deepens budget deficit. Given that in most cases these funds are earmarked, this solution is always problematic.

The General Treasury Management chapter also budgets CZK 10.0 billion for 2025 to deal with the aftermath of 2024 September's floods and subsequent reconstruction. In May 2025, CZK 4.1 billion was transferred to the Ministry of Agriculture, but has not yet been spent.[2]

Another risk that is starting to materialize is the financing of non-teaching staff in regional education from September. The originally considered shift of this obligation to local and regional authorities (local government subsector) will not take place. The government must therefore transfer funds from other items within the approved state budget. However, it is not yet clear from the available information where the resources will be moved from.

Meanwhile, other parts of the general government sector are developing in line with past trends. At the end of April, local and regional authorities reported a surplus of CZK 7.4 billion, while public health insurance companies generated a deficit of CZK 1.2 billion (both in cash terms).

From a medium-term perspective, it should be reiterated that the current setting of tax and expenditure policies does not ensure the lawful consolidation trajectory beyond 2026 will be met. As in the

[1] At the end of May, only CZK 88.7 million remained in the government´s budget reserve.

[2] Some chapters have funds available to deal with the consequences of 2024 September's floods in the form of claims arising from unconsumed expenditure from last year's CZK 30 billion budget amendment (approx. CZK 12 billion). The spending of these expenditures at the state budget level in 2025 is so far being done in the form of transfers to the State Fund for Transport Infrastructure and the State Environmental Fund.

Convergence Programme of the Czech Republic[3] (April 2024), the Fiscal Forecast of the Czech Republic[4] (May 2025) envisages in the autonomous scenario of public finance development that **the structural deficit will be higher than one foreseen by the Act No. 23/2017 Coll., on the Rules of Budgetary Responsibility, as amended, as early as 2027**. The magnitude of this imbalance increases gradually over time. This is even after deducting additional defence spending, which will be exempt from national fiscal rules and will be allowed to exceed the approved expenditure frameworks by a defined amount (see below). This points to the urgent need for further consolidation steps by any future government if the trajectory of improving the structural balance is to be maintained.

The medium-term horizon of the Czech public finances will be significantly affected by the expected increase in defence spending. This will be facilitated by adjustments to both national and European fiscal rules. In the first case, an amendment to the budgetary rules is being discussed[5], which allows the government to increase defence spending above 2% of GDP[6] (in cash terms) as part of the update of the expenditure framework of the state budget and state funds carried out in August. At the European level, the Czech Republic, together with 16 other Member States, has requested the activation of the so-called national escape clause. The national escape clause for defence expenditure represents the possibility of deviating from the net expenditure path set by the EU Council between 2025 and 2028 by up to 1.5% of GDP compared to 2021. Increasing this spending under the national escape clause will result in an increase in the general government deficit and debt to higher levels than projected in the current scenario. The EC's indicative projections, assuming a linear use of the full increase in public spending allowed by the escape clause until 2028, suggest that the deficit could be 1.3% of GDP higher in 2028 (around CZK 125 billion) than if net expenditure were to grow in line with the specified trajectory. EC itself has warned[7] that the use of the national escape clause will require fiscal measures in the following years to meet the requirements of the EU fiscal framework and to maintain fiscal sustainability in the medium term. Thus, as already pointed out by the CFC, the gradual erosion of fiscal space in favour of defence spending will limit the space for other spending priorities, possibly requiring measures on the revenue side of public budgets in the future.

---

[3] https://www.mfcr.cz/en/eu-and-international-affairs/euro-area-accession-strategy/convergence-programme/2024/convergence-programme-of-the-czech-republic-april-55707.

[4] https://www.mfcr.cz/en/fiscal-policy/macroeconomic-analysis/fiscal-forecast-and-fiscal-outlook/2025/fiscal-forecast-of-the-czech-republic-may-2025-59935.

[5] Bill amending certain acts in connection with the adoption of the Public Finance Management and Control Act (Parliamentary press No. 856).

[6] The exemption covers the period 2026 to 2033.

[7] Council Recommendation - Allowing Czechia to deviate from the maximum growth rates of net expenditure as set by the Council under Regulation (EU) 2024/1263 (Activation of the national escape clause).